99th Congress
2d Session

COMMITTEE PRINT

S. PRT.
99-159

TAX EXPENDITURES

Relationships to Spending Programs and Background Material on Individual Provisions

COMMITTEE ON THE BUDGET
UNITED STATES SENATE

JUNE 1986

Printed for the use of the Committee on the Budget

48-178 O

U.S. GOVERNMENT PRINTING OFFICE
WASHINGTON : 1986

For sale by the Superintendent of Documents, Congressional Sales Office
U.S. Government Printing Office, Washington, DC 20402

5252-3

COMMITTEE ON THE BUDGET

PETE V. DOMENICI, New Mexico, *Chairman*

WILLIAM L. ARMSTRONG, Colorado
NANCY LANDON KASSEBAUM, Kansas
RUDY BOSCHWITZ, Minnesota
ORRIN G. HATCH, Utah
MARK ANDREWS, North Dakota
STEVEN D. SYMMS, Idaho
CHARLES E. GRASSLEY, Iowa
ROBERT W. KASTEN, Wisconsin
DAN QUAYLE, Indiana
SLADE GORTON, Washington
JOHN C. DANFORTH, Missouri

LAWTON CHILES, Florida
ERNEST F. HOLLINGS, South Carolina
J. BENNETT JOHNSTON, Louisiana
JIM SASSER, Tennessee
GARY HART, Colorado
HOWARD M. METZENBAUM, Ohio
DONALD W. RIEGLE, Jr., Michigan
DANIEL PATRICK MOYNIHAN, New York
J. JAMES EXON, Nebraska
FRANK R. LAUTENBERG, New Jersey

G. William Hoagland, *Staff Director*
Richard N. Brandon, *Minority Staff Director*
W. Thomas Foxwell, *Director of Publications*

LETTER OF TRANSMITTAL

To the Members of the Committee on the Budget:

The Congressional Budget and Impoundment and Control Act of 1974 requires the Budget Committees to examine tax expenditures as they develop the Federal budget. Numerous provisions of the tax code confer benefits upon individuals and institutions that are comparable to direct Federal spending. These provisions have substantial impact on the level of Federal receipts and are seldomly reviewed in comparison to the scrutiny given to the direct spending programs.

This Committee print has been prepared to revise the March, 1982 Committee Print on Tax Expenditures. It is a compendium that briefly describes the operation and impact of each tax expenditure; indicates the authorization and rationale for enactment; shows the revenue loss attributable to each provision and, where available, the percentage distribution of that loss by income class; and cites a selected bibliography for each provision within its functional class.

Tax expenditures are becoming increasingly important in developing the budget. They are generally enacted as permanent legislation and thus are comparable to continuing direct spending entitlement programs. They cause significant revenue losses and are often less efficient than related outlay programs. In some cases, they cause economic distortion and result in higher inflation and interest rates and in less growth.

This compendium was prepared jointly by the Budget Committee staff, the Joint Committee on Taxation, the Congressional Budget Office, and the Congressional Research Service.

Nothing in this volume should be interpreted as representing the views or recommendations of the Budget Committee or any of its members.

Sincerely,

Lawton Chiles,
Ranking Minority Member.

Pete V. Domenici,
Chairman.

CONTENTS

	Page
Letter of transmittal	III
Introduction	1
(050) National defense:	
Exclusion of benefits and allowances to Armed Forces personnel	9
Exclusion of military disability pensions	11
(150) International affairs:	
Exclusion of income earned abroad by United States citizens	13
Foreign sales corporations (FSC) and interest-charge domestic international sales corporations (DISC)	17
Deferral of income of controlled foreign corporations	21
Exclusion of certain allowances paid to U.S. Government employees abroad	25
(250) General science, space, and technology:	
Expensing of research and development expenditures	29
Credit for increasing research activities	33
Suspension of regulations relating to allocation under section 861 of research and experimental expenditures	37
(270) Energy:	
Expensing of exploration and development costs: oil, gas, and other fuels	41
Excess of percentage over cost depletion: oil, gas, and other fuels	45
Capital gains treatment of royalties from coal	51
Alternative fuel production credit	55
Alcohol fuel credit	59
Exclusion of interest on State and local government industrial development bonds for energy production facilities	63
Residential energy credits:	
Supply incentives	65
Conservation incentives	69
Alternative, conservation and new technology credits:	
Supply incentives	73
Conservation incentives	77
(300) Natural resources and environment:	
Expensing of exploration and development costs, nonfuel minerals	81
Excess of percentage over cost depletion, nonfuel minerals	83
Capital gains treatment of certain timber income	87
Investment credit and 7-year amortization for reforestation expenditures	89
Capital gains treatment of iron ore	91
Exclusion of interest on State and local government pollution control and sewage and solid waste disposal facilities bonds	93
Exclusion of payments in aid of construction of water, sewage, gas, and electric utilities	97

Page

(300) Natural resources and environment—Continued
Tax incentives for preservation of historic structures 99
Premature accrual of mine reclamation and similar expenses 103
(350) Agriculture:
Expensing of certain capital outlays 105
Capital gains treatment of certain income 109
Deductibility of patronage dividends and certain other items of cooperatives 113
Exclusion of certain cost-sharing payments 117
(370) Commerce and housing credit:
Exemption of credit union income 119
Exclusion of interest on life insurance and annuity savings 121
Excess bad debt reserves of financial institutions 125
Tax-free reorganizations of financially troubled thrift institutions 129
Special taxable income adjustment for life insurance companies 131
Small life insurance company taxable income adjustment 133
Tax exemption for certain insurance companies 135
Deductions of unpaid losses of property and casualty insurance companies 137
Deduction for life insurance company reserves 139
PAL accounts for mutual property and casualty insurance companies 141
Exclusion of interest on State and local industrial development bonds 143
Exclusion of interest on State and local housing bonds for owner-occupied housing 147
Exclusion of interest on State and local housing bonds for rental housing 151
Expensing of construction period interest and taxes for low-income housing 153
Deductibility of mortgage interest on owner-occupied homes 155
Deductibility of property tax on owner-occupied homes 159
Deferral of capital gains on home sales 163
Exclusion of capital gains on home sales for persons age 55 and over 165
Depreciation on rental housing in excess of straight-line, and depreciation on buildings (other than rental housing) in excess of straight-line 167
Accelerated depreciation on property other than leased property 173
Amortization of business start-up costs 179
Capital gains other than agriculture, timber, iron ore, and coal 181
Capital gains at death 187
Non-recognition of gain on property distribution in liquidation 191
Reduced rates on the first $100,000 of corporate income 195
Investment credit, other than ESOP's, rehabilitation of structures, reforestation, leasing, and energy property 199
Dividend exclusion 203
Deductibility of non-mortgage interest in excess of investment income 207
Finance leasing 209
Exclusion for certain income from discharge of indebtedness 213
Expensing of $5,000 of depreciable business property 215
Reinvestment of dividends in stock of public utilities 217
Expensing of magazine and newspaper circulation expenditures 219

Page

(370) Commerce and housing credit—Continued

Deferral of gain on installment sales 221
Completed-contract method of accounting 223
Expensing costs of removing architectural barriers to the handicapped and elderly 225
Cash method of accounting, other than agriculture 227
Reserve method for bad debt deductions, other than financial institutions 229
Amortization of trademark expenses 231

(400) Transportation:

Deferral of tax on shipping companies 233
Exclusion of interest on State and local government IDB's for mass transit 235

(450) Community and regional development:

Five-year amortization for housing rehabilitation 237
Investment credit for rehabilitation of structures other than historic structures 239
Exclusion of interest on State and local government IDB's for airports and other large-scale public facilities 241

(500) Education, training, employment, and social services:

Exclusion of scholarship and fellowship income 243
Exclusion of interest on State and local student loan bonds 245
Exclusion of interest on State and local bonds for private educational institutions 247
Targeted jobs credit 249
Parental personal exemption for students age 19 or over 253
Employer educational assistance 255
Exclusion of certain meals and lodging furnished by nonmilitary employers 257
Exclusion of contributions to prepaid legal services plans 259
Exclusion for employer-provided child care 261
Employee stock ownership plans (ESOP's) 263
Cafeteria plans 269
Exclusion for parsonage allowances 271
Exclusion of miscellaneous fringe benefits 273
Credit for child and dependent care expenses 277
Deduction for two-earner married couples 281
Deduction for adoption expenses 283
Deductibility of charitable contributions (educational, health and other institutions) 285

(550) Health:

Exclusion of employer contributions for medical insurance premiums and medical care 289
Deductibility of medical expenses 293
Exclusion of interest on State and local hospital bonds 295
Tax credit for orphan drug research 297

(600) Income security:

Exclusion of untaxed social security benefits (disability, retired workers, and dependents and survivors) 299
Exclusion of untaxed railroad retirement system benefits 303
Exclusion of untaxed workmen's compensation benefits 305
Exclusion of special benefits for disabled coal miners 307
Exclusion of untaxed unemployment insurance benefits 309
Exclusion of public assistance benefits 311

Page

(600) Income security—Continued

Net exclusion of pension contributions and earnings:
- Plans for employees and self-employed individuals 313
- Individual retirement plans 317

Exclusion of other employee benefits:
- Premiums on group-term life insurance 321
- Premiums on accident and disability insurance 323

Additional exemption for the blind 325
Additional exemption for the elderly 327
Credit for the elderly and the permanently and totally disabled 329
Deductibility of casualty and theft losses 333
Earned income credit 335
Exclusion for employer-provided death benefits 337
Exclusion of income earned by certain benefit organizations 339

(700) Veterans benefits and services:

Exclusion of disability compensation, pensions, and GI bill benefits. 343
Exclusion of interest on State and local veterans housing bonds 345

(800) General government:

Credits for political contributions 347

(850) General purpose fiscal assistance:

Exclusion of interest on general purpose State and local debt 349
Deductibility of non-business State and local taxes (other than on owner-occupied homes) 353
Tax credit for corporations receiving income from doing business in U.S. possessions 355

(900) Interest:

Deferral of interest on savings bonds 359

Appendix A

Distribution of selected items of tax expenditures under individual income class 361

Appendix B

Forms of tax expenditures 366

INTRODUCTION

This compendium gathers basic information concerning 129 Federal tax provisions currently treated as tax expenditures. These provisions are the same as those listed in Tax Expenditure Budgets prepared for fiscal year 1987 by the Joint Committee on Taxation and the Congressional Budget Office.

With respect to each tax expenditure, this compendium provides:

> An estimate of the Federal revenue loss associated with the provision for individual and corporate taxpayers, for fiscal years 1986–1991;
>
> The legal authorization for the provision (e.g., Internal Revenue Code section, Treasury Department regulation, or Treasury ruling);
>
> A description of the tax expenditure, including an example of its operation where this is useful;
>
> A brief analysis of the impact of the provision;
>
> A brief statement of the rationale for the adoption of the tax expenditure where it is known, including relevant legislative history; and
>
> References to selected bibliography:

The information presented for each of these tax expenditures is not intended to be exhaustive or definitive. Rather, it is intended to provide an introductory understanding of the nature, effect, and background of each of these provisions. Good starting points for further research on each item are listed in the selected bibliography following each provision.

Appendix A contains estimates of revenue loss distributed by expanded income class for 15 tax expenditures affecting individuals. No other income distribution estimates are provided for the remaining individual or corporate tax expenditures, since to do so would require making assumptions for which substantiating data do not exist.

Defining Tax Expenditures

Tax expenditures are revenue losses resulting from Federal tax provisions that grant special tax relief designed to encourage certain kinds of behavior by taxpayers or to aid taxpayers in special circumstances. These provisions may, in effect, be viewed as the equivalent of a simultaneous collection of revenue and a direct budget outlay of an equal amount to the beneficiary taxpayer.

Section 3(a)(3) of the Congressional Budget and Impoundment Control Act of 1974 specifically defines tax expenditures as:

> . . . those revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability; . . . .

In the legislative history of the Congressional Budget Act, provisions classified as tax expenditures are contrasted with those provisions which are part of the "normal structure" of the individual and corporate income tax necessary to collect government revenues.

The listing of a provision as a tax expenditure in no way implies any judgment about its desirability or effectiveness relative to other tax or nontax provisions that provide benefits to specific classes of individuals and corporations. Rather, the listing of tax expenditures, taken in conjunction with the listing of direct spending programs, is intended to allow Congress to scrutinize all Federal programs relating to the same goals—both nontax and tax—when it develops its annual budget. Only when tax expenditures are considered will Congressional budget decisions take into account the full spectrum of Federal programs.

Because any qualified taxpayer may reduce tax liability through use of a tax expenditure, such provisions are comparable to entitlement programs under which benefits are paid to all eligible persons. Since tax expenditures are generally enacted as permanent legislation, it is important that, as entitlement programs, they be given thorough periodic consideration to see whether they are efficiently meeting the national needs and goals that were the reasons for their initial establishment.

The concept of tax expenditures is relatively new. Tax expenditure budgets which list the estimated annual revenue losses associated with each tax expenditure first were required to be published in 1975 as part of the Administration budget for fiscal year 1976, and have been required to be published by the Budget Committees since 1976. The tax expenditure concept is still being refined, and therefore, the classification of certain provisions as tax expenditures continues to be discussed. Nevertheless, there has been widespread agreement for the treatment as tax expenditures of most of the provisions included in this compendium.[1]

As defined in the Congressional Budget Act, the concept of tax expenditure refers to the corporation and individual income taxes. Other parts of the Internal Revenue Code—excise taxes, employment taxes, estate and gift taxes—also have exceptions, exclusions, refunds and credits, such as a gasoline tax exemptions for nonhighway uses, which are not included in this report because they are not parts of the income tax.

Administration Fiscal Year 1986 Tax Expenditure Budget

There are several differences between the tax expenditures shown in this publication and the tax expenditure budget found in Special Analysis G of the Administration's FY87 budget. This publication includes some items not included in the Special Analysis G list and uses revenue estimates done by the Joint Committee on Taxation. In addition, there are differences in the treatment of patronage dividends and capital gains at death.

---

[1] For a discussion of some of the conceptual problems involved in defining tax expenditures, see *The Budget of the United States Government, Fiscal Year 1987,* "Special Analysis G."

Major Types of Tax Expenditures

Tax expenditures may take any of the following forms: (1) exclusions, exemptions, and deductions, which reduce taxable income; (2) preferential tax rates, which reduce taxes by applying lower rates to part or all of a taxpayer's income; (3) credits, which are subtracted from taxes as ordinarily computed; and (4) deferrals of tax, which result from delayed recognition of income or from allowing in the current year deductions that are properly attributable to a future year.

The amount of tax relief per dollar of each exclusion, exemption, and deduction increases with the taxpayer's marginal tax rate. Thus, the exclusion from tax of interest income from State and local bonds saves $50 for every $100 of interest for a taxpayer in the 50 percent tax bracket, whereas the savings for the taxpayer in the 25 percent bracket is only $25. Similarly, the extra exemption for persons age 65 or over and any itemized deduction is worth twice as much in tax savings to a taxpayer in a 50 percent bracket as to one in the 25 percent bracket.

A tax credit is subtracted directly from the tax liability that would otherwise be due; thus the amount of tax reduction is the amount of the credit—which does not depend on the marginal tax rate.

Order of Presentation

The tax expenditures are presented in an order which generally parallels the budget functional categories used in the Congressional budget, i.e., tax expenditures related to "national defense" are listed first, and those related to "international affairs" are listed next. In a few instances, two or three closely related tax expenditures derived from the same Internal Revenue Code provision have been combined in a single summary to avoid repetitive references even though the tax expenditures are related to different functional categories. This parallel format is consistent with the requirement of section 301(d)(6) of the Budget Act, which requires the tax expenditure budgets published by the Budget Committees as parts of their April 15 reports to present the estimated levels of tax expenditures "by major functional categories."

Rationale

The material on each tax expenditure contains a brief statement of the rationale for the adoption of the tax expenditure where it is known. These rationales are the principal ones which were publicly given at the time the provisions were enacted.

Further Comment

In the case of a number of tax expenditures, additional information is provided under the heading "Further Comment." It is material which either focuses attention on some of the principal issues related to a provision or describes recent legislative proposals to amend a provision. This is material that does not fit within the other elements of the format of the compendium—either in the "Description," "Impact," or "Rationale" sections. As the examples which are provided in the descriptions of only some of the tax expenditures, the "Further Comment" sections are included only where they were deemed to be useful. Providing information under the "Further Comment" sections for only certain tax expenditures in no way implies any judgment about these provisions.

Estimating Tax Expenditures

The estimated revenue losses for all the listed tax expenditures are based upon work done by the staff of the Joint Committee on Taxation.

In calculating the revenue loss from each tax expenditure, it is assumed that only the provision in question is deleted and that all other aspects of the tax system remain the same. In using the tax expenditure estimates, several points should be noted.

First, in some cases, if two or more items were eliminated, the combination of changes would probably produce a lesser or greater revenue effect than the sum of the amounts shown for the individual items.

Second, the amounts shown for the various tax expenditure items do not take into account any effects that the removal of one or more of the items might have on investment and consumption patterns or on any other aspects of individual taxpayer behavior, general economic activity, or decisions regarding other Federal budget outlays or receipts.

Finally, the revenue effect of new tax expenditure items added to the tax law may not be fully felt for several years. As a result, the eventual annual cost of some provisions is not fully reflected until some time after enactment. Similarly, if items now in the law were eliminated, it is unlikely that the full revenue effects would be immediately realized.

However, these tax expenditure estimating considerations are similar to estimating considerations involving entitlement programs. Like tax expenditures, annual budget estimates for each transfer and income security program are computed separately. However, if one program, such as veterans' pensions, were either terminated or increased, this would affect the level of payments under other programs, such as welfare payments. Also, like tax expenditure estimates, the elimination or curtailment of a spending program, such as military spending or unemployment benefits, would have substantial effects on consumption patterns and economic activity that would directly affect the levels of other spending programs. Finally, like tax expenditures, the budgetary effect of terminating certain entitlement programs would not be fully reflected until several years later because the termination of benefits is usually only for new recipients with persons already receiving benefits continued under "grandfather" provisions.

All revenue loss estimates are based upon the tax law enacted as of December 31, 1985. All estimates have been rounded to the nearest $0.1 billion.

SUM OF TAX EXPENDITURE ITEMS BY TYPE OF TAXPAYER, FISCAL YEARS, 1986-91

[In billions of dollars]

Fiscal year	Corporations and individuals	Corporations	Individuals
1986	424.5	NA	NA
1987	450.5	97.1	353.4
1988	486.2	101.1	385.1
1989	529.8	107.7	422.1
1990	578.3	116.0	462.3
1991	631.5	124.4	507.1

NOTE.—These totals represent the mathematical sum of the estimated fiscal year effect of each of the tax expenditure items included in this publication. The limitations on the use of the totals are explained in the text.

Source: Staff of the Joint Committee on Taxation.

Selected Bibliography

Bosworth, Barry P. *Tax Incentives and Economic Growth.* Washington, D.C.: The Brookings Institution, 1984.

Brannon, Gerard M. "Tax Expenditures and Income Distribution: A Theoretical Analysis of the Upside-Down Subsidy Argument," in: Henry J. Aaron and Michael J. Boskin, eds., *The Economics of Taxation.* Washington, D.C.: The Brookings Institution, 1980: 87-98.

Browning, Jacqueline, M. "Estimating the Welfare Cost of Tax Preferences." Public Finance Quarterly, v. 7, No. 2, April 1979: 199-219.

Freeman, Roger A. *Tax Loopholes: The Legend and the Reality.* Washington, D.C.: American Enterprise Institute for Public Policy Research, 1973.

Goode, Richard. *The Individual Income Tax.* Washington, D.C.: The Brookings Institution, 1976.

Klimschot, JoAnn. *The Untouchables: A Common Cause Study of the Federal Tax Expenditure Budget.* Washington, D.C.: Common Cause, 1981.

McClure, Charles E., Jr. *Must Corporate Income Be Taxed Twice?* Washington, D.C.: The Brookings Institution, 1979.

Noto, Nonna A. "Tax Expenditures: The Link Between Economic Intent and the Distribution of Benefits Among High, Middle, and Low Income Groups." Multilith No. 80-99E. Washington, D.C.: The Library of Congress. Congressional Research Service, May 22, 1980.

Pechman, Joseph A. ed., *Comprehensive Income Taxation.* Washington, D.C.: The Brookings Institution, 1977.

———. *What Should Be Taxed: Income or Expenditures?* Washington, D.C.: The Brookings Institution, 1980.

———. *Who Paid the Taxes, 1966-85,* Washington, D.C.: The Brookings Institution, 1985.

Schroeher, Kathy. *Gimme Shelters: A Common Cause Study of the Review of Tax Expenditures by the Congressional Tax Committees.* Washington, D.C.: Common Cause, 1978.

Steuerle, Eugene, and Michael Hartzmark. "Individual Income Taxation, 1947–79." National Tax Journal, v. 34, No. 2, June 1981: 145–166.

Sunley, Emil M. "The Choice Between Deductions and Credits." National Tax Journal, v. 30, No. 3, September 1977: 243–247.

Surrey, Stanley S., *Pathways to Tax Reform*. Cambridge, Mass.: Harvard University Press, 1973.

Surrey, Stanley S., and Paul R. McDaniel. "The Tax Expenditure Concept and the Legislative Process," in: Henry J. Aaron and Michael J. Boskin, eds. *The Economics of Taxation*. Washington, D.C.: The Brookings Institution, 1980: 123–144.

———. *Tax Expenditures*, Cambridge Massachusetts, Harvard University Press, 1985.

U.S. Congress. Congressional Budget Office. *Reducing the Federal Budget: Strategies and Examples, Fiscal Years 1982–1986*. 1981.

———. *Tax Expenditures: Current Issues and Five-Year Budget Projections, 1984–1988*, 1983.

———. *Tax Expenditures: Current Issues and Five-Year Budget Projections for Fiscal Years 1982–1986*, 1981.

———. Joint Committee on Internal Revenue Taxation. *General Explanation of the Revenue Act of 1971*, Dec. 15, 1972.

———. Joint Committee on Taxation. *An Analysis of Proposals Relating to Broadening the Base and Lowering the Rates of the Income Tax*, Sept. 24, 1982.

———. *Estimates of Federal Tax Expenditures for Fiscal Years 1986–1990*. Prepared for the Committee on Ways and Means and the Committee on Finance. Committee Print. 99th Cong., 1st sess., Apr. 12, 1985.

———. *General Explanation of the Crude Oil Windfall Profits Tax Act of 1980*, 1980.

———. *General Explanation of the Economic Recovery Tax Act of 1981*, Dec. 29, 1981.

———. *General Explanation of the Revenue Act of 1978*, Mar. 12, 1979.

———. *General Explanation of the Deficit Reduction Act of 1984*, December 1984.

———. *General Explanation of the Tax Equity and Fiscal Responsibility Act of 1982*, Dec. 31, 1982.

———. *General Explanation of the Tax Reform Act of 1976*, Dec. 29, 1976.

———. Senate. Committee on the Budget. *Tax Expenditure Limitation and Control Act of 1981 (S. 193)*. Hearing. 97th Cong., 1st sess., Nov. 24, 1981.

———. *Tax Expenditures: Relationships to Spending Programs and Background Material on Individual Provisions*, 1978.

U.S. Department of the Treasury. *Blueprints for Basic Tax Reform*, Jan. 17, 1977.

———. *The President's 1978 Tax Program: Detailed Descriptions and Supporting Analyses of the Proposals*, Jan. 30, 1978.

U.S. General Accounting Office. *Tax Expenditures: A Primer*. PAD 80-26. 1979.

U.S. Office of Management and Budget. "*Tax Expenditures.*" Special Analysis G, Budget of the United States Government, fiscal year 1986. Februrary 1985.

Wagner, Richard E., *The Tax Expenditure Budget: An Exercise in Fiscal Impressionism.* Washington, D.C.: Tax Foundation, 1979.

Weidenbaum, Murray L., *The Case for Tax Loopholes.* St. Louis: Center for the Study of American Business, Washington University, 1978.

Witte, John F. "The Distribution of Federal Income Tax Expenditures." Policy Journal Studies, v. 12, September 1983: 131–153.

EXCLUSION OF BENEFITS AND ALLOWANCES TO ARMED FORCES PERSONNEL

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	2.2		2.2
1987	2.3		2.3
1988	2.4		2.4
1989	2.6		2.6
1990	2.7		2.7
1991	2.7		2.7

Authorization

Sections 112 and 113,[1] Treasury Regulation Sec. 1.61-2,[2] and court decisions.

Description

Military personnel are not taxed on a variety of in-kind benefits and cash payments given in lieu of such benefits. These tax-free benefits include quarters and meals or—alternatively—cash allowances for these purposes, certain combat pay, and a number of less significant items.

Impact

All military personnel receive one or more tax-free benefits, which are generally greater in the higher pay brackets. Under the graduated tax structure, the after-tax value of any exclusion or deduction increases with the individual's tax bracket. Differentials built into the military pay, benefit and allowance structure in recognition of seniority and rank, are amplified because of the tax structure. As a result, the distribution of net pay to service personnel may be altered.

---

[1] The word "Section" denotes a section of the Internal Revenue Code of 1954, as amended, unless otherwise noted.

[2] Reference to "Treasury regulations" are to Income Tax Regulations unless otherwise noted.

Rationale

Although the principle of exemption of armed forces benefits and allowances appeared early in the history of the income tax, it has evolved through subsequent specific statutes, regulations, revenue rulings, and court decisions. For some benefits, the rationale was a specific desire to reduce tax burdens of military personnel during wartime (as in the use of combat pay provisions); other preferences were apparently based on the belief that certain types of benefits were not strictly compensatory but rather intrinsic elements in the military structure akin to the "for the convenience of the employer" concept in the private sector.

Further Comment

Administrative difficulties and complications could be encountered in taxing some military benefits and allowances that are tax exempt; for example, it could be difficult to value meals and lodging when the option to receive cash is not available. However, eliminating the exclusions and adjusting pay scales accordingly could result in a more complete accounting for the actual costs of military pay in the Federal budget, create greater evenhandedness in the treatment of military personnel of comparable rank and seniority, and make "actual" salary more apparent to recipients.

Selected Bibliography

Binkin, Martin. *The Military Pay Muddle.* Washington, D.C.: The Brookings Institution, April 1975.

Gordon, Howard W. "The Federal Income Tax Significance of Being a POW or MIA." Taxes, v. 53, Sept. 1975: 551–560.

Owens, William L. "Exclusions From, and Adjustments to, Gross Income," Air Force Law Review, v. 19, spring 1977: 90–99.

(050) National Defense

EXCLUSION OF MILITARY DISABILITY PENSIONS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	0.1		0.1
1987	.1		.1
1988	.1		.1
1989	.1		.1
1990	.1		.1
1991	.2		.2

Authorization

Section 104(a)(4), 104(b), and 38 U.S.C. Section 314.

Description

Service personnel who joined the armed forces on or before September 24, 1975, and have at least (1) a 30-percent disability or (2) 20 years of service and any amount of disability may draw retirement pay from the Department of Defense based on either percentage of disability or years of service. If the chosen pension is less than 50 percent of basic pay, it will be raised to 50 percent during the first 5 years of retirement. Pay based on percentage of disability is fully excluded from gross income under section 104. If pay is based on years of service, only the portion that would have been paid on the basis of disability is excluded from income.

Members of the armed forces who join the service after September 24, 1975, are allowed to exclude military disability payments only if the payments are directly attributable to combat-related injuries. The term "combat-related injury" means personal injury or sickness which is incurred (1) as a direct result of armed conflict, (2) while engaged in extra-hazardous service, (3) under conditions simulating war, or which is (4) caused by an instrumentality of war.

Disability payments administered by the Veterans Administration are excluded from gross income. These payments are based on degree of disability rather than length of service. An individual who joins the armed forces after September 24, 1975, retires on disability, and receives taxable disability payments from the Department of Defense is allowed to exclude from income an amount equivalent to what the individual would have been entitled to if the payments had been received from the Veterans Administration.

Impact

Disability payments that are exempt from tax provide more net income than the same level of taxable benefits. The tax benefit of this provision increases as the pensioner's marginal tax rate increases. Thus, the after-tax pension benefits may increase as a percentage of after-tax active duty pay as the individual's tax bracket increases.

Rationale

Prior to 1976, military personnel could exclude from income pensions for personal injuries paid by the Department of Defense. The rationale was not clear for the exclusion, which was adopted in 1942 during World War II. In limiting the exclusion in 1976, Congress sought to eliminate abuses by armed forces personnel who were classified as disabled shortly before becoming eligible for retirement in order to obtain tax-exempt treatment for their pension benefits. After retiring from military service, most of these individuals would earn income from other employment while receiving tax-free military pensions.

Selected Bibliography

Binkin, Martin. *The Military Pay Muddle.* Washington, D.C.: The Brookings Institution, April 1975.

Bittker, Boris I. "Tax Reform and Disability Pensions—the Equal Treatment of Equals." Taxes, v. 55, June 1977: 363–367.

U.S. Congress. Joint Committee on Taxation. *General Explanation of the Tax Reform Act of 1976,* Dec. 29, 1976: 129–131.

U.S. Department of Defense. Defense Manpower Data Center. Office of the Actuary. *DOD Statistical Report on the Military Retirement System.* Alexandria, Va., 1980: 222p.

———. Defense Manpower Data Center. Office of the Actuary. *DOD Statistical Report on the Military Retirement System.* Alexandria, Va., 1984: 251p.

EXCLUSION OF INCOME EARNED ABROAD BY UNITED STATES CITIZENS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	1.5		1.5
1987	1.6		1.6
1988	1.7		1.7
1989	1.8		1.8
1990	1.9		1.9
1991	2.0		2.0

Authorization

Sections 911-912.

Description

A U.S. citizen or resident is generally taxed on his worldwide income, with the allowance of a foreign tax credit for foreign taxes paid on the foreign income. However, under section 911 of the Internal Revenue Code, an individual who has his tax home in a foreign country and who is either present overseas for 11 out of 12 consecutive months or who is a bona fide resident of a foreign country for an entire taxable year can elect to exclude an amount of his foreign earned income from his gross income. The maximum exclusion is $80,000 in 1985 increasing to $85,000 in 1988, and to $90,000 in 1989, and to $95,000 in 1990.

An individual meeting the eligibility requirements may also elect to exclude his housing costs above a floor which is an amount equal to 16 percent of the salary of a Federal employee at Grade 14, Step 1. The combined earned income exclusion and housing amount exclusion may not exceed the taxpayer's total foreign earned income for the taxable year. An exclusion for employer-provided amounts attributable to living in a camp located in a foreign country is also provided. The provision contains a denial of double benefits by reducing such things as the foreign tax credit by the amount attributable to excluded income.

Some form of foreign earned income exclusion has been in the tax laws since 1926. The system described above replaces a system of deductions and exclusions for excess costs of living abroad that was adopted by the Congress in 1977 and was effective for years 1978 through 1981. Adoption of the present system greatly increased the estimated revenue loss from this provision.

Section 911 does not apply to salaries received from the U.S. Government. However, section 912, discussed separately, exempts from tax certain allowances that are received by Federal civilian employees working abroad and in Alaska and Hawaii. The principal exempt allowances are for high local living costs, education, and housing.

Impact

Some U.S. citizens living abroad pay no income taxes to the countries in which they reside. The present foreign earned income exclusion of section 911 allows their income up to the appropriate ceiling to be free from United States tax as well.

U.S. citizens residing abroad and paying no income taxes to a foreign government receive a tax benefit in the form of lower overall U.S. taxes. The tax burden is zero if the individual's earnings equal or are below the limitation. Where the individual's earnings exceed the limitation, his rates on the excess will be lower than a comparably compensated citizen living in the United States. This is because the first dollar of excess is treated, in effect, as the first dollar of income taxed at the lowest marginal rates. The same holds true for unearned income, that is, a U.S. citizen eligible for the foreign earned income exclusion will pay a lower rate of tax on his investment income than a similarly situated citizen all of whose earnings are subject to full U.S. tax.

If the individual pays foreign income taxes on the wages, those taxes cannot be credited against U.S. income tax liability on other foreign income. The value of the exclusion is, therefore, the difference between the tax savings and the amount of foreign tax credit which would have been claimed on the excluded amount in the absence of the exclusion. This difference is the greatest, and thus the exclusion has the greatest value, for taxpayers living in those countries where tax rates on the excludable portion are nonexistent or much lower than the U.S. rate.

In addition to the U.S. citizens who directly claim the benefits from this favorable treatment on their tax returns, overseas employers also benefit to the extent that salary levels are lower because of the exclusion. In fact, many U.S. firms follow a practice of "tax protection," under which employees' salaries are set at levels to give them the same after-tax salary they would receive in the United States. When this practice is followed, all the direct benefits of section 911 accrue to the employers rather than the employees. U.S. corporations that bid on overseas construction projects assert that the salary savings make them more competitive with foreign bidders, some of the employees of which also enjoy similar tax benefits under the laws of their home countries.

Rationale

A less restrictive form of section 911 was first enacted in 1926 to encourage foreign trade. After World War II, the exclusion was justified as part of the Marshall Plan to encourage persons with technical knowledge to work abroad. The most recent expansion of the provision was intended to provide an incentive to U.S. businesses to send U.S. workers abroad. Although the provision was revised on several occasions, dollar limitations were first enacted in 1953 at $20,000 and $35,000. The latter figure was reduced to $25,000 in 1964.

Further Comment

After enactment of the Tax Reform Act of 1976, which substantially limited the foreign earned income exclusion, controversy developed about those revisions. Congress acted to delay the application of those changes and, in fact, the revisions made in the 1976 act never applied. Instead, a series of special deductions for cost of living, housing, and educational expenses, as well as combinations of special deductions and flat exclusions was enacted. The 1981 amendments replaced that system. The large, but limited, exclusion enacted was really a compromise with those who wanted a complete exclusion of foreign earned income. It is likely that attempts to gain a complete exclusion will continue.

Selected Bibliography

Christie, John H. "Citizenship as a Jurisdictional Basis for Taxation: Section 911 and the Foreign Source Income Expense." Brooklyn Journal of International Law, v. 8, winter 1982: 109–158.

Fuller, James P. "Rules Governing Income Earned Abroad and Employers Allowances Simplified by ERTA." Journal of Taxation, v. 56, Jan. 1982: 2.

Henry, Robert J. "Visit Abroad, Professor, and Pay No Income Tax." University of Cincinnati Law Review, v. 52, summer 1983: 700–759.

Klein, Robert B. "Tax Changes Affecting United States Expatriates." New York University Forty-First Annual Institute on Federal Taxation, 1983: 29-1–29-22.

de Laperouse, Marc. "U.S. Expatriate Taxation: The Economic Recovery Act of 1981." New York Journal of International Law and Politics, v. 15, fall 1982: 73–140.

Papahronis, John. "Taxation of Americans Abroad Under the ERTA: An Unnecessary Windfall." Northwestern Journal of International Law and Business, v. 4, autumn 1982: 566–600.

Russo, Samuel, M. and Marvin Ellenbogen. "Expatriate Taxation: The 1981 Statutory Rules." International Tax Journal, v. 8, Dec. 1981: 85–97.

Sobel, Renee Judith. "United States Taxation of It's Citizens Abroad: Incentive or Equity?" Vanderbilt Law Review, v. 38, Jan. 1985: 101–160.

Stillabower, Linda M. and Lawrence C. Phillips. "Income Exclusion and Tax Treaty Applications to Earnings of U.S. Citizens Abroad." International Tax Journal, v. 10, Sept. 1984: 445–454.

U.S. Congress. Joint Committee on Taxation: *General Explanation of the Economic Recovery Tax Act of 1981.* Committee Print. 97th Cong., 1st sess., Dec. 29, 1981.

Vorachek, Darlene A. "Taxation of Americans Abroad: The Economic Recovery Act of 1981." George Washington Journal of International Law and Economics, v. 16, 1981: 179-200.

(150) International Affairs

FOREIGN SALES CORPORATIONS (FSC)

AND

INTEREST-CHARGE DOMESTIC INTERNATIONAL SALES CORPORATIONS (DISC)

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986		1.0	1.0
1987		1.0	1.0
1988		1.2	1.2
1989		1.3	1.3
1990		1.4	1.4
1991		1.5	1.5

Authorization

Sections 921-927 and 991-997.

Description

FOREIGN SALES CORPORATIONS

In general

A Foreign Sales Corporation (FSC) is a foreign corporation that is organized in a qualifying foreign country or U.S. possession, and meets certain other requirements. Typically, FSC's are wholly owned subsidiary corporations through which parent corporations channel their export sales.

A portion of the export income of an eligible FSC is exempt from Federal income tax. Also, a domestic corporation is allowed a 100-percent dividends-received deduction for dividends distributed from the FSC out of earnings attributable to certain foreign trade income. Thus, there is no corporate level tax imposed on a portion of the income from exports.

Under the General Agreement on Tariffs and Trade (GATT) rules, a country may exempt export income from tax only if the economic processes which give rise to the income take place outside the country. In accordance with these rules, a FSC must have a foreign presence, it must have economic substance, and activities that relate to its export income must be performed by the FSC outside the U.S. customs territory. Furthermore, the income of the FSC must be determined according to specific transfer prices: either actual prices for sales between unrelated independent parties or, if the sales are between related parties, formula prices intended to comply with GATT's requirement of arm's-length prices.

Two options are available to eligible small businesses to alleviate the potential burden of the foreign presence and economic activity requirements: they may form a small FSC (which need not meet certain economic process requirements) or an interest-charge DISC (discussed below).

Tax savings

The tax savings from using a FSC result principally from (1) the income allocation rules, which generally allow 23 percent of the combined profit of the parent and FSC from export sales to be attributed to the FSC; and (2) the tax exemption itself, which is from tax on at least $^{16}/_{23}$ of the FSC's income ($^{15}/_{23}$ of the FSC's income in the case of a corporate shareholder).

The revenue effect shown below includes approximately $100 billion in carried over DISC funds.

Transfer pricing rules

The transfer pricing rules provide that taxable income may be based upon a transfer price that allows the FSC to derive taxable income attributable to the sale in an amount which does not exceed the greatest of (1) 1.83 percent of the foreign trading gross receipts derived from the sale of the property; (2) 23 percent of the combined taxable income of the FSC and the related person (these two pricing rules are termed the administrative pricing rules); or (3) taxable income based upon the actual sales price, but subject to the rules provided in section 482. The rules for allocating FSC profits are generally much more favorable than the otherwise applicable tax law standard (sec. 482), which allocates profits between two or more corporations under common control as if transactions between them occurred at an arm's-length price. Generally, if the section 482 rules were applied to FSC's, no sales commission, or a relatively small sales commission only, would be allocated to the FSC, while the proportionately larger profits from production would go to the parent corporation.

Ineligible exports

Certain exports are not eligible for FSC treatment. These include oil, gas, and products subject to export control under the Export Administration Act of 1969. The FSC exemption on exported military goods is limited to half the amount allowed for other exported goods.

Interest-Charge DISC's

An interest-charge DISC is similar to a DISC under prior law. However, its benefits are limited generally to small businesses with $10 million or less of export income. As under the prior law DISC provisions, a U.S. corporation will qualify as an interest-charge DISC if at least 95 percent of its assets are related to export functions, and if at least 95 percent of its gross receipts stem from export-related sale or lease transactions.

Special allocation rules (which are the same as under the prior-law DISC rules) provide that an interest-charge DISC is deemed to have earned either (1) 50 percent of the combined taxable income of the parent corporation and DISC from export sales, or (2) 4 percent of the gross receipts from export sales, whichever is greater. In the alternative, the normal arm's-length intercompany pricing rules provided by section 482 of the Code can be used.

In general, neither the DISC nor its shareholders pay significant tax on the DISC's earnings as long as the undistributed DISC income is invested in qualified assets; the duration may be indefinite; however, an interest charge is imposed each year on the basis of the cumulative amount of income deferred at the end of the year. The income allocable to the DISC that is not eligible for deferral is deemed to be distributed annually to its parent corporation.

Impact

The foreign sales corporation provision reduces the marginal tax rate on most FSC-related export income to 39.1 percent (46 percent × 85 percent of income (nonexempt portion is 85 percent in the case of corporate parent)).

Whether U.S. exporters reduce export prices in response to reduced effective tax rates is unclear. To the extent they do, exports would be subsidized.

The overall impact of the FSC is anticipated to be approximately the same as the DISC provisions it replaced. According to the Treasury Department, the overall impact of DISC under prior law in stimulating exports was small in comparison to its annual revenue cost. Over the long run, the Treasury contends that adjustments in exchange rates tend to offset any effects such subsidies may have on the balance of trade. U.S. exports have increased dramatically since the original DISC provisions were added, but the increase is said to be primarily due to changes in the value of the dollar and worldwide inflation.

On the other hand, many U.S. companies which utilize these provisions argue that export subsidies should be retained because in their view: (1) the law has substantially increased exports which, in turn, have increased U.S. employment levels; and (2) U.S. industry can remain competitive only if the United States provides subsidies to offset the variety of export promotion devices employed by other countries.

Rationale

Originally provided by the Revenue Act of 1971, DISC benefits were intended to stimulate exports and enhance the attractiveness of domestic manufacturing vis-a-vis manufacturing through foreign subsidiaries. Restrictions on DISC benefits for natural resource products and scarce products were adopted in the Tax Reduction Act of 1975. An incremental rule was adopted in the Tax Reform

Act of 1976. It was designed to continue to provide stimulus to exports, but with a smaller revenue loss. The FSC provisions were adopted in the Deficit Reduction Act of 1984 as a replacement for the DISC provisions, in response to international concern expressed by the European Economic Community under GATT regarding the DISC rules. The FSC provisions were intended to provide approximately the same subsidy to exporters as the DISC provisions.

Selected Bibliography

Block, Neal J., Ralph J. Gilbert and Karen A. Kuenster. "Transition From DISC to a Foreign Sales Corporation: Tax and Other Considerations." International Lawyer, v. 19, winter 1985: 343-360.

Brown, Charles R. and Eileen O'Connor. "The New Tax Law: Its Impact in Other Areas." Practical Accountant, v. 19: 44–46, 48–50, 52, 54, 56.

Bruce, Charles M. "Treasury's FSC Regulations and the USVI Amendments." Tax Notes, v. 25: 1174–1176.

Brumbaugh, David L. "Taxation of Foreign-Source Income: A Survey; A Brief Overview of Concepts, Provisions, and Issues in the Federal Taxation of Foreign Source Income." No. 83-636E. Washington, D.C.: The Library of Congress, Congressional Research Service, June 16, 1983.

Feenstra, Robert C. "Extending Tax Incentives to U.S. Service Exports: Reevaluating the DISC Program." Tax Notes, v. 22, Jan. 23, 1984: 329–336.

Narcross, Kenneth J. "Interest Charge Discs and Small FSCs: A Comparison of the Tax Benefits." Taxes, v. 62, Feb. 1985: 134–139.

U.S. Congress. Joint Committee on Taxation. Committee on Finance. *Replacement of Domestic International Sales Corporation (DISCs) description of S. 1804 (Foreign Sales Corporation Act).* Committee Print. 98th Cong., 1st sess., Nov. 1983.

———. *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984.* Committee Print. 98th Cong., 2d sess., Dec. 31, 1984: 1037-1070.

Zaiken, David P., Diane L. Renfroe and Robert J. Magilligan. "Use of Foreign Sales Corporations Enhanced by Approach of Temporary Regulations." Journal of Taxation, v. 62, May 1985: 266–273.

(150) International Affairs

DEFERRAL OF INCOME OF CONTROLLED FOREIGN CORPORATIONS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986		0.4	0.4
1987		.4	.4
1988		.5	.5
1989		.5	.5
1990		.5	.5
1991		.6	.6

Authorization

Sections 11(f), 882, and 951-964.

Description

A U.S. corporate parent of a foreign subsidiary is not taxed on the subsidiary's income until the income is remitted (or "repatriated") to the parent. The deferral of U.S. tax liability on the subsidiary's income continues indefinitely as long as the income is reinvested in the subsidiary or other foreign subsidiaries, rather than remitted to the U.S. parent. A tax credit in the amount of total worldwide foreign taxes paid on repatriated income after gross-up (i.e. after adding back foreign income taxes paid to the actual dividend) is allowed at the time of repatriation.

An exception to the general deferral principle is provided under subpart F of the Code (sections 951-964). Under these sections, income from so-called tax haven activities conducted by corporations controlled by U.S. shareholders is deemed distributed to the shareholders and taxed to them as earned. Tax haven activities are generally sales and services artificially structured to channel income from high tax jurisdictions to lower tax jurisdictions. They also include the receipt of personal income.

By comparison to the treatment of foreign subsidiary income, income from all foreign branches of U.S. corporations is taxed the same as income earned in the United States since the branches are parts of U.S. corporations.

Companies that operate subsidiaries in countries with effective income tax rates lower than the U.S. rate may receive tax benefits from this provision.

Rationale

Historically, the United States has not taxed foreign source income of foreign corporations on the premise that only domestic corporations or income with a U.S. source is subject to U.S. jurisdiction. The separate corporate status of foreign subsidiaries of domestic corporations generally has been respected. In 1962, these principles were abrogated for tax haven income under subpart F of the Code. Subpart F was subsequently strengthened by the Tax Reduction Act of 1975, the Tax Reform Act of 1976, the Tax Equity and Fiscal Responsibility Act of 1982, and the Deficit Reduction Act of 1984. Such income is taxed even though earned abroad and even though not repatriated. This provision was enacted in part to prevent multinational companies from shifting profits to tax havens.

Further Comment

Opponents of deferral allege it encourages investment in foreign countries and reduces domestic investment. They argue this reduces U.S. tax revenues and U.S. exports, and adversely affects the balance of payments, the balance of trade, and domestic employment. Proponents deny such allegations, and argue that deferral must be continued for U.S. corporations to remain competitive with foreign companies in overseas markets.

Deferral of tax on foreign profits is not neutral compared to investment in the United States in the sense that if the foreign country tax rate is less than the U.S. tax rate and the income is not going to be repatriated, a U.S. corporation has a tax incentive to invest abroad using a foreign subsidiary instead of investing at home. However, the deferral rules do neutralize advantages foreign competitors may have over U.S. corporations operating abroad. Moreover, there are also offsetting tax rules which favor investment in the United States by domestic companies rather than abroad, such as, limiting the investment tax credit and Accelerated Cost Recovery System (ACRS) to assets used in the United States.

Moreover, simply ending deferral would not necessarily result in increased U.S. taxes on the low taxed income of foreign subsidiaries. This is because the U.S. foreign tax credit is computed on an overall worldwide basis. Accordingly, income taxes in excess of U.S. rates paid to high tax foreign countries would offset U.S. taxes imposed on income from low tax countries. This could be mitigated, and revenue increased, by coupling ending deferral with changes in the foreign tax credit limitation.

Selected Bibliography

American Law Institute. Federal Income Tax Project Tentative, Draft No. 14. *International Aspects of United States Income Taxation.* Philadelphia, Pa., Mar. 22, 1985.

Brownlee, Oswald H. "Taxing the Income From U.S. Corporation Investments Abroad." Washington, D.C.: American Enterprise Institute for Public Policy Research, 1979.

Gravelle, Jane G. and Donald W. Kiefer. "Deferral and DISC: Two Targets of Tax Reform." Multilith 78-20E. Washington, D.C.: The Library of Congress, Congressional Research Service, Feb. 3, 1978.

Hartman, David G. "Deferral of Taxes on Foreign Source Income." National Tax Journal, v. 30, Dec. 1977: 457-462.

———. "The Linkage of Tax Policy and Foreign Investment." NBER Reporter, Nov. 26, 1984.

Humpage, Owen F. "U.S. Taxation of Foreign-Source Corporate Income: A Survey of the Issues." Economic Review. Federal Reserve Bank of Cleveland, winter 1980-81: 1-18.

Musgrave, Peggy. "Tax Preferences to Foreign Investment," in: U.S. Congress. Joint Economic Committee. *The Economics of Federal Subsidy Programs.* Part 2—"International Sudsidies," July 15, 1972: 176-219.

Pugh, Richard C. "The Deferral Principle and U.S. Investment in Developing Countries," in: Robert Hellawell, ed. *United States Taxation and Development Countries.* New York: Columbia University Press, 1980: 267-302.

U.S. Congress. House. Committee on Ways and Means. *General Tax Reform.* Panel Discussions, Part II—"Tax Treatment of Foreign Income," 93rd Cong., 1st sess., Feb. 28, 1973: 1671-1888.

———. *Recommendations of the Task Force on Foreign Source Income.* Committee Print. 95th Cong., 1st sess., Mar. 8, 1977.

———. *U.S. Taxation of Foreign Income—Deferral and the Foreign Tax Credit.* Committee Print. 94th Cong., 1st sess., Sept. 27, 1975.

Joint Committee on Taxation. *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984.* Dec. 31, 1984: 346-473.

U.S. Department of the Treasury. *Essays in International Taxation.* 1976, Tax Policy Research Study No. 3, 1976. See particularly: Gary Hufbauer and David Foster. "U.S. Taxation of the Undistributed Income of Controlled Foreign Corporations" and: Marcia Field and Richard Gordon, "Tax Treatment of Income from International Shipping."

EXCLUSION OF CERTAIN ALLOWANCES PAID TO U.S. GOVERNMENT EMPLOYEES ABROAD

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	0.2	.....	0.2
1987	.2	.....	.2
1988	.2	.....	.2
1989	.2	.....	.2
1990	.2	.....	.2
1991	.2	.....	.2

Authorization

Section 912.

Description

U.S. citizens employed as civilians outside the continental United States (and in some cases in Alaska and Hawaii) by the U.S. Government may exclude from their gross incomes certain allowances which supplement their base salaries. The allowances in question are designed primarily to cover certain living expenses. A number of expenses, such as moving expenses, generally would be deductible as employee business expenses under current law. But other allowances, notably those for housing, cost-of-living differentials, education expenses, and home leave travel, would be taxable income in the absence of the special exclusion under section 912.

Section 912 refers to three categories of allowances, citing in each case the statutes which authorize their payment.

(a) *Foreign areas allowances* (subsection (1) of sec. 912). The first category enumerated in section 912 refers to the various allowances paid to Government employees in foreign areas. There are about 50 such allowances, which fall into eight major groups: living quarters, cost-of-living differentials (by comparison with Washington, D.C.), education of dependents, travel, expenses associated with transfers, expenses associated with separation from the foreign service, representation expenses, and official residences (limited to certain officials).

(b) *Cost-of-living allowances* (subsection (2) of sec. 912). The second category excluded from taxable income by section 912 is cost-of-living allowances, if paid in accordance with regulations approved by the President, to employees stationed in foreign countries, in the U.S. territories and possessions or in Alaska or Hawaii. To qualify for the exclusion, these cost-of-living allowances must meet the second condition of being paid in accordance with regulations approved by the President.

(c) *Peace Corps allowances* (subsection (3) of sec. 912). The third category mentioned in section 912 covers certain allowances paid to Peace Corps volunteers and their families. This paragraph, added in 1961, is essentially limited to travel expense allowances and living allowances which do not constitute basic compensation. Termination payments and leave allowances for such individuals are specifically excluded from section 912.

Impact

The Treasury Department has estimated that in 1975, approximately 100,000 civilian Government employees received one or more allowances that are excluded from income under section 912. Approximately 40,000 of these persons were employed in foreign countries, about 20,000 in U.S. territories, and about 40,000 in Alaska and Hawaii. Roughly 60 percent of the total were civilian employees of the Department of Defense.

The value of the section 912 exemption for allowances received by Federal civilian employees working abroad increases with the recipient's tax bracket. The value therefore depends on a variety of factors including the level of the recipient's Federal salary, the extent of his or her other income, and the amount of his or her itemized deductions.

The aggregate amount of allowances is not reported, nor does each agency report allowances separately in its budget. For example, the Defense Department, the largest single employer of personnel covered by section 912, records some civilian allowances with those of the military. The estimated revenue cost in 1975 of excluding the allowances from taxable income was roughly $100 million, based on salary levels, location, and assumed family size. This figure relates only to the revenue side of the budget; it does not take into account that the tax-exempt nature of the allowances may in part be reflected in lower salaries or lower allowances. If the allowances were subject to tax there would have to be some offsetting increase on the expenditure side of the budget in the amounts paid to maintain the same level of disposable income for the employees. According to a 1977 Report by a Task Force of the House Committee on Ways and Means, however, the recruitment and retention of personnel for Federal agencies for overseas duty posts in practice had not, at least at that time, presented significant problems.

An overseas civilian employee receiving tax-free allowances may be better off than a comparable employee stationed in the United States. In many cases, the allowances that section 912 exempts cover not just the excess costs an employee incurs by being abroad (over what he or she would incur at the 48 contiguous States), but all costs involved. For example, the living quarters allowance provides for completely free housing, not just reimbursement for the housing costs in excess of those an employee would have incurred in the 48 contiguous States.

Rationale

In 1943, Congress exempted from tax cost-of-living allowance of employees and officers of the Foreign Service, and cost-of-living allowances of other U.S. Government employees stationed outside the continental United States, if received in accordance with regulations approved by the President. The reasons for excluding the allowances were that wartime inflation was seriously reducing their value, particularly for Foreign Service personnel in Europe, that increases in allowances were partly nullified by the increase in tax, resulting from the Revenue Act of 1943, and that the State Department did not have the funds or authority to compensate the recipients for the added burden of the tax.

The Foreign Service Act of 1946 expanded the allowances and benefits authorized for foreign service officers and employees. The additional allowance included amounts payable for housing, cost-of-living, representation costs, and travel expenses (for moving, home leave, and sick leave). That act proceeded a tax exemption for such additional allowances.

In 1960, Congress added an exemption for allowances authorized under certain other acts and confirmed the IRS position that post differentials were not excludable. In 1961, certain Peace Corps allowances were added to the list of exclusions. The Treasury Department at that time expressed concern at expanding the list of benefits excluded from income.

Selected Bibliography

Papahronis, John. "Taxation of Americans Abroad Under the ERTA: An Unnecessary Windfall." Northwestern Journal of International Law and Business, v. 4, autumn 1982: 566–600.

U.S. Congress. Joint Committee on Taxation. *General Explanation of the Economic Recovery Tax Act of 1981,* 41–48, 97th Cong. 1st sess., Dec. 29, 1981.

Vorachek, Darlene A. "Taxation of Americans Abroad: The Economic Recovery Tax Act of 1981." George Washington Journal of International Law and Economics, v. 16, 1981: 179–200.

(250) General Science, Space, and Technology

EXPENSING OF RESEARCH AND DEVELOPMENT EXPENDITURES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	0.2	3.7	3.9
1987	.2	3.3	3.5
1988	.2	3.4	3.6
1989	.2	3.4	3.6
1990	.2	3.5	3.7
1991	.2	3.5	3.7

Authorization

Section 174.

Description

As a general rule, business expenditures to develop or create an asset which has a useful life that extends beyond the taxable year, such as expenditures to develop a new consumer product or improve a production process, must be capitalized and cannot be deducted in the year paid or incurred. These costs usually may be recovered through depreciation or amortization deductions over the useful life of the asset, or on a disposition or abandonoment of the asset.

However, under section 174, a taxpayer may elect to deduct currently the amount of certain research or experimental expenditures incurred in connection with the taxpayer's trade or business. In the case of research expenditures resulting in property which does not have a determinable useful life (such as secret processes or formulae), the taxpayer alternatively may elect to deduct the costs ratably over a period of not less than 60 months. Treasury regulations define expenditures eligible for the deduction elections as "research and development costs in the experimental or laboratory sense."

Expenditures for the acquisition or improvement of land, or expenditures for the acquisition or improvement of depreciable or depletable property to be used in connection with research, are not eligible for the deduction elections. However, research expenditures which may be expensed or amortized under section 174 include depreciation (cost recovery) or depletion allowances with respect to depreciable or depletable property used for research. Expenditures to ascertain the existence, location, extent, or quality of mineral deposits, including oil and gas, are not eligible for section 174 elections.

The amount of deduction allowed under section 174 is not reduced by the amount, if any, of the credit provided under section 30 for certain incremental research or experimental expenditures.

Impact

The accelerated deduction allowed for research expenditures operates, as does accelerated capital cost recovery, to defer tax liability.

For example, if a corporation incurs expenditures of $1 million in the taxable year for research wages, supplies, and depreciation allowances, the corporation may currently deduct that amount from its taxable income, producing a cash flow (at a 46-percent marginal tax rate) of $460,000. The value to the corporation of current expense treatment is the amount by which the present value of the immediate deduction exceeds (for example) the present value of periodic deductions which otherwise could be taken over the useful life of the asset, such as a patent, resulting from the research expenditures.

The direct beneficiaries of this provision are businesses that undertake research. Mainly, these are large manufacturing corporations or high technology firms. Also, the deduction is available to investors in so-called R. & D. tax shelter partnerships, and can be used by such individuals to offset income from sources other than the partnership.

For accounting purposes, certain research and development expenditures are to be charged to expense when incurred (Statement of Financial Accounting Standards No. 2, October 1974). These costs include the cost of materials consumed in research, depreciation of equipment or facilities used in research, and costs of personnel engaged in research.

Rationale

Section 174 was enacted as part of the Internal Revenue Code of 1954. The purposes cited for the provision were to encourage research expenditures and to eliminate difficulties and uncertainties under prior law in distinguishing trade or business expenditures from research expenditures.

Selected Bibliography

Bozeman, Barry. "Tax Incentives for R&D: A Critical Evaluation." Research Policy, v. 13, Feb. 1984: 21-31.

Collins, Eileen L. *An Early Assessment of Three R&D Tax Incentives Provided by the Economic Recovery Tax Act of 1981.* Washington, D.C.: National Science Foundation, 1983.

Gallagher, Thomas. *Tax Policy and Industrial Innovation.* Multilith No. 80-32E. Washington, D.C.: The Library of Congress. Congressional Research Service, Jan. 11, 1980.

Gravelle, Jane G. *Provisions in the Economic Recovery Tax Act of 1981 Affecting Research and Development Expenditures.* Washington, D.C.: The Library of Congress, Congressional Research Service, Sept. 4, 1981.

Kaplan, Robert S., et al. *Tax Policies for R&D and Technological Innovations.* 4 vols. Pittsburgh: Carnegie-Mellon University, 1977.

Landau, Ralph and Bruce N. Hannay, eds. *Taxation, Technology and the U.S. Economy.* New York: Pergamon Press, 1981. See particularly: George Carlson. "Tax Policy and the U.S. Economy" (a version of which was published as Office of Tax Analysis Paper 45, U.S. Treasury Department, Jan. 1981), pp. 63-86, and: Joseph Cordes. "Tax Policies for Encouraging Innovation: A Survey," pp. 87-99.

National Science Foundation. *Tax Policy and Innovation.* Preliminary Papers, April 24, 1981.

Panluk, Jonathan. "Computer Software and Tax Policy." Columbia Law Review, v. 84, Dec. 1984: 1992-2031.

Strain, William J. "Tax and Other Incentives to Reduce R&D Costs." Corp. Mgt. Tax Conference, 1981: 227-254.

U.S. Congress. Congressional Budget Office. *The Productivity Problem Alternatives for Action.* Chapter 5—"Policies to Encourage Efficient Technologies," Jan. 1981.

———. Joint Committee on Taxation. *General Explanation of the Economic Recovery Tax Act of 1981.* Dec. 31, 1981: 117-137.

Wood, Robert W. "Research and Development Expenditures Under the Economic Recovery Tax Act." Taxes, v. 59, Nov. 1981: 777-783.

(250) General Science, Space, and Technology

CREDIT FOR INCREASING RESEARCH ACTIVITIES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	(1)	1.1	1.1
1987	(1)	.4	.4
1988	(1)	.1	.1
1989	(1)	(1)	(1)
1990	(1)	(1)	(1)
1991	(1)	(1)	(1)

[1] Less than $50 million.

Authorization

Section 30. This credit expired December 31, 1985 and had not been reinstated at publication time.

Description

A nonrefundable, 25-percent income tax credit is allowed for certain research expenditures paid or incurred in carrying on a trade or business of the taxpayer. The credit applies only to the extent that the taxpayer's qualified research expenditures for the taxable year exceed the average amount of the taxpayer's yearly qualified research expenditures in the specified base period (generally, the preceding 3 taxable years).

The credit provision adopts the definition of research used for purposes of the special deduction rules under section 174, but subject to certain exclusions. The amount of the section 174 deduction is not reduced by the amount of the credit.

Research expenditures eligible for the incremental credit consist of (1) in-house expenditures by the taxpayer for research wages and supplies used in research, plus certain amounts paid for research use of laboratory equipment, computers, or other personal property; (2) 65 percent of amounts paid by the taxpayer for contract research conducted on the taxpayer's behalf; and (3) if the taxpayer is a corporation, 65 percent of the taxpayer's expenditures (including grants or contributions) pursuant to a written research agreement for basic research to be performed by universities or certain scientific research organizations.

Impact

The credit has the effect of reducing the net cost to a business of incurring qualified research expenditures in excess of its research expenditures in a base period (generally, the preceding 3 years). The credit does not provide a benefit to firms which continue the same dollar amount of research spending. However, since the base period amount is not adjusted for inflation, businesses may benefit from the credit even though the level of their research activities (in constant dollars) remains the same.

In general, the credit is available only for research expenditures incurred in carrying on a trade or business of the taxpayer. As a result of this requirement, the credit generally is not available for research expenditures incurred by a so-called R. & D. tax shelter partnership or by a newly organized business prior to the date the entity is considered to be engaged in carrying on a trade or business, nor is it available to an existing business which incurs research expenditures to enter into a new trade or business. Also, no more than 50 percent of otherwise qualifying current year expenditures can be eligible for the credit, even if the base period amount is less than 50 percent of current expenditures.

Individuals to whom the credit is properly allocable from a partnership or other business may use the credit in a particular year only to offset the amount of tax attributable to that portion of the individual's taxable income derived from that business. For example, an individual cannot use pass-throughs of the credit from a research partnership to offset tax on income from the other sources.

Rationale

Section 30 was enacted as part of the Economic Recovery Tax Act of 1981. The purpose cited was that a substantial tax credit for incremental research expenditures was needed to overcome the reluctance of many ongoing companies to bear the significant costs of staffing and supplies, and certain equipment expenses such as computer charges, which must be incurred to initiate or expand research programs in a trade or business.

Selected Bibliography

Black, Robert L. "The Research Credit: R&D in the Post-ERTA Period." 41st Annual New York University Institute on Federal Taxation, New York, N.Y., 1983: 12-1—12-46.

Bozeman, Barry. "Tax Incentives for R&D: A Critical Evaluation." Research Policy, v. 13, Feb. 1984: 21-31.

Brown, Kenneth M., ed. *The R&D Tax Credit: Issues in Tax Policy and Industrial Innovation.* Washington, D.C.: American Enterprise Institute for Public Policy, 1984.

Collins, Eileen L. *An Early Assessment of Three R&D Tax Incentives Provided by the Economic Recovery Tax Act of 1981.* Washington, D.C.: National Science Foundation, 1983.

Corrigan, Richard. "The R&D Tax Credit Is the Tax Break That Almost Everyone Seems to Love." National Journal, v. 17, Mar. 16, 1985: 577-579.

Eisner, Robert. "The New Incremental Tax Credit for R&D: Incentive or Disincentive?" National Tax Journal, v. 37, June 1984: 171-183.

Gallagher, Thomas. "Tax Policy and Industrial Innovation." Multilith No. 80-32E. Washington, D.C.: The Library of Congress, Congressional Research Service, Jan. 11, 1980.

Gravelle, Jane G. "Provisions in the Economic Recovery Tax Act of 1981 Affecting Research and Development Expenditures." Washington, D.C.: The Library of Congress, Congressional Research Service, Sept. 4, 1981.

———. "The Tax Credit for Research and Development: An Analysis." Multilith No. 85-6. Washington, D.C.: The Library of Congress, Congressional Research Service, Jan. 25, 1985.

Kaplan, Robert S., et al. *Tax Policies for R&D and Technological Innovations.* 4 vols. Pittsburgh: Carnegie-Mellon University, 1977.

Landau, Ralph and Bruce Hannay, eds. *Taxation, Technology and the U.S. Economy.* New York: Pergammon Press, 1981. See particularly: George Carlson. "Tax Policy and the U.S. Economy" (a version of which was published as Office of Tax Analysis Paper 45, U.S. Treasury Department, Jan. 1981), pp. 63-86, and: Joseph Cordes. "Tax Policies for Encouraging Innovation: A Survey," pp. 87-99.

National Science Foundation. *Tax Policy and Innovation.* Preliminary Papers, Apr. 24, 1981.

Panluk, Jonathan. "Computer Software and Tax Policy." 84 Columbia Law Review, v. 84, Dec. 1984: 1992-2031.

Silversmith, Gary. "Tax Credit for Increasing Research Activities." American Bar Association Journal, v. 69, Jan. 1983: 90-93.

Strain, William J. "Tax and Other Incentives to Reduce R&D Costs." Corp. Mgt. Tax Conference, 1981: 227-254.

U.S. Congress. Congressional Budget Office. *The Productivity Problem: Alternatives for Action.* Chapter 5—"Policies to Encourage Efficient Technologies," Jan. 1981.

———. House. Committee on Ways and Means. *Research and Experimentation Tax Credit.* Hearing. 98th Cong. 2d sess., Aug. 2, 1984.

———. Joint Committee on Taxation. *General Explanation of the Economic Recovery Tax Act of 1981,* Dec. 31, 1981: 117-137.

Wood, Robert W. "Research and Development Expenditures Under the Economic Recovery Tax Act." Taxes, v. 59, Nov. 1981: 777-783.

(250) General Science, Space, and Technology

SUSPENSION OF REGULATIONS RELATING TO ALLOCATION UNDER SEC. 861 OF RESEARCH AND EXPERIMENTAL EXPENDITURES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986		0.1	0.1
1987			
1988			
1989			
1990			
1991			

Authorization

Section 223, Public Law 97–34, Economic Recovery Tax Act of 1981, and section 126, Public Law 98–369, for taxable years beginning August 1, 1985, Deficit Reduction Act of 1984. The suspension expired and had not been reinstated at publication time.

Description

In determining foreign source taxable income for purposes of computing the foreign tax credit limitation (sec. 904), and for other tax purposes, sections 861–863 require taxpayers to allocate or apportion expenses between foreign-source income and U.S.-source income.

Treasury regulation section 1.861–8 (published in 1977) sets forth detailed rules for allocating and apportioning several categories of expenses, including deductible research and experimental expenditures ("research expenses"). The regulation provides that research expenses are ordinarily considered definitely related to all gross income reasonably connected with one or more of 32 product categories based on two-digit classifications of the Standard Industrial Classification ("SIC") system. Research expenses are not traced solely to the income generated by the particular product which benefited from the research activity. Instead these expenses are associated with all the income within the SIC product group in which the product is classified.

Research expenses identified with an SIC product group are generally apportioned to foreign-source income based on the ratio of total foreign-source sales receipts (or, at the taxpayer's option and subject to certain conditions, total foreign-source gross income) within the SIC product group to the taxpayer's total worldwide sales receipts (or gross income) within the SIC product group. However, research expenses incurred to meet legal requirements imposed with respect to improvement or marketing of specific products or processes are allocable entirely to one geographic source if the research and development cannot reasonably be expected to generate income (beyond de minimis amounts) outside that geographic source. In addition, the regulation provides that 30 percent of research expense is apportioned to the geographic source where over half of the taxpayer's research and development is performed. A taxpayer can choose to apportion to this geographic source greater than 30 percent of research expense if he establishes that a higher percentage is warranted because the research and development is reasonably expected to have a very limited or long-delayed application outside that geographic source. Treasury regulation section 1.861-8 generally requires a small allocation of research expense to foreign-source income than a predecessor regulation proposed in 1973 would have required.[1]

The Economic Recovery Tax Act of 1981 (ERTA) provided that, for a taxpayer's first 2 taxable years beginning after the date of its enactment (August 13, 1981), all research and experimental expenditures (within the meaning of Code sec. 174) which were paid or incurred in those taxable years, for research activities conducted in the United States, were to be allocated or apportioned to sources within the United States. The 2-year moratorium on the application of the research and experimental expense allocation rules of Treasury regulation section 1.861-8 did not apply to taxable years following the taxpayer's second taxable year commencing after August 13, 1981.

ERTA directed the Treasury Department to conduct a study of the impact of the allocation of research expenses under Treasury regulation section 1.861-8 on U.S.-based research activities. In June 1983 the Secretary of the Treasury submitted his report on the mandated study to the Senate Committee on Finance and the House Committee on Ways and Means.[2] To allow the Congress to consider further the results of the study and to analyze fully the relative equity and efficiency of the moratorium as a tax incentive for research, the moratorium was effectively extended for 2 years under the Deficit Reduction Act of 1984.

Under the 1984 Act, for taxable years beginning generally after August 13, 1983 and before August 1, 1985, all of a taxpayer's research and experimental expenditures (within the meaning of Code sec. 174) attributable to research activities conducted in the United States are to be allocated to sources within the United States for purposes of computing taxable income from U.S. sources and from sources partly within and partly without the United States.

---

[1] See 38 Fed. Reg. 15,840 (1973).

[2] See Department of the Treasury, "The Impact of the Section 861-8 Regulation on U.S. Research and Development" (June 1983).

Impact

Domestic research expenses do not reduce foreign source income even though they generate that income. The foreign tax credit available to a company taking advantage of this moratorium is thus increased and a greater amount of foreign taxes can be credited against U.S. tax. As a result, for the first time since a limitation was added to the foreign tax credit, foreign taxes are allowed to offset U.S. taxes imposed on U.S. source income. The moratorium benefits those companies whose foreign tax burden is above or near the U.S. rate.

Rationale

The Congress believed that the portion of Treasury regulation section 1.861-8 which relates to research expenses warrants careful study because of its possible effect on U.S.-based research activities.

Taxpayers that are required to allocate research expenses for purposes of the foreign tax credit claim that more deductions must be allocated overseas than are allowed as deductions by the foreign country. Thus, taxpayers claim that their foreign tax credit limitation is lower than the foreign taxes paid and that they will lose foreign tax credits.

Because of the application of the regulation, taxpayers argue that they must transfer research activities to the foreign country in order to obtain a deduction in that country and thus obtain a full foreign tax credit on the income earned in that country. The Congress believed that the transfer of research activities overseas would not be in the best interest of the United States. Therefore, the Congress concluded that the impact of the allocation of research expense under Treasury regulation section 1.861-8 on U.S.-based research activities should be examined. Congress believed that a temporary moratorium on the application of the research and experimental expense allocation rules of the regulation was appropriate while the impact of those rules was under study.

Congress also recognized that tax incentives for research frequently increased Federal budget deficits and that some tax incentives for research could be more equitable or efficient than others. In light of fiscal restraints, Congress considered it important that the relative equity and efficiency of the moratorium on the application of the Treasury regulation section 1.861-8 research expense rules, compared to alternative tax incentives, be fully analyzed before any particular tax incentive was permanently adopted.

Selected Biblography

Benvignati, Anita M. "The Tax Treatment of Research and Development (R&D) Expenditures by Multinational Corporations: The Impact of Regulations 1.861-8." OTA Paper 43. Washington, D.C.: U.S. Department of the Treasury, Office of Tax Analysis, Dec. 1980.

Bischel, Jon E. "Optimizing the Benefits From R&D Expenses Under the Allocation and Apportionment Regs." Journal of Taxation, v. 48, No. 6, June 1978: 332-339.

Buja, Christopher. "The Effect of Section 1.861-8 Regulations on the Location of R&D Activity." Tax Notes, v. 19, June 13, 1983: 955-964,

Byrne, James S. "Opposition Developing to Allocation Rules." Tax Notes, v. 6, Nov. 29, 1976: 3-4, 14-16.

Duncan, E. W. "Allocation and Apportionment of Deductions Under the Final 1.861-8 Regulations." Tax Executive, v. 30, No. 1, Oct. 1977: 1-15.

Feinschreiber, Nancy Abbott. "Apportionment of R&D Expenses: The New Statutory Provisions." Journal of International Taxation, v. 8, No. 1, Oct. 1981: 5-12.

U.S. Congress. House. Committee on Ways and Means. *Research and Experimentation Source Allocation Rules.* Hearings. 98th Cong., 2d sess., Oct. 26, 1984.

Joint Committee on Taxation. *General Explanation of the Economic Recovery Tax Act of 1981.* Committee Print. 97th Cong., 1st sess., Dec. 29, 1981: 141-142.

———. *Background and Issues Relating to Research and Experimentation Expense Source Allocation Rules.* Committee Print. 98th Cong., 1st sess., Oct. 20, 1983.

———. Senate. Committee on Finance. *Research and Experimental Source Allocation Rules.* Hearings. 98th Cong., 1st sess., June 17, 1983.

Woo, Mai Nguyen. "Research and Development at Home or Abroad? The Economics of IRS Regulations 1.861-8." Economic Report No. 9, Institute for Research on the Economics of Taxation. Washington, D.C.: Mar. 17, 1982.

Wood, Robert W. "Research and Development Expenditures Under the Economic Recovery Tax Act." Taxes, v. 59, No. 11, Nov. 1981: 777-783.

(270) Energy

EXPENSING OF EXPLORATION AND DEVELOPMENT COSTS: OIL, GAS, AND OTHER FUELS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	1.2	1.1	2.3
1987	1.1	1.7	2.8
1988	1.1	1.7	2.8
1989	1.2	1.8	3.0
1990	1.2	1.9	3.1
1991	1.3	2.0	3.3

Authorization

Sections 263(c), 291, 465, 616–17, 704(d), and 1254 of the Internal Revenue Code of 1954, as most recently amended by sections 68, 432, and 712 of Public Law 98–369 (Deficit Reduction Act of 1984).

Description

Under standard accounting practices, the cost of acquiring or improving an asset designed to produce income over several years must be deducted only as the asset loses value. Taxpayers engaged in oil, gas, and geothermal energy production can, however, generally deduct the amount spent on intangible drilling costs in the year that the expenditure is made, i.e., they may expense, rather than capitalize, the qualifying expenses. Ninety-nine percent of the revenue lost through expensing of IDC's involves oil and gas exploration and development. The costs that are permitted this special treatment include the amounts paid for fuel, labor, repairs, hauling, and supplies that are used in drilling oil, gas, and geothermal wells, the costs of clearing ground in preparation for drilling, and the intangible (i.e., nonsalvageable) costs of constructing derricks, tanks, pipelines, and other structures and equipment necessary for drilling and preparing wells. Typically, these outlays comprise between 75 and 90 percent of total costs. By expensing rather than capitalizing these costs, taxes on income are effectively deferred; it is as if an interest-free loan equal to the delayed tax liability were offered.

There are limits on this provision. Most notably, noncorporate taxpayers can only expense the portion of their expenditures they actually have at risk, i.e, subject to loss, in the project. In addition, recapture rules apply to post-1985 expenditures if a taxpayer's interest in the project is sold, requiring that a portion of the gain be taxed as ordinary income rather than capital gains. Also, under the corporate tax preference rules of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), intangible drilling costs were reduced by 15 percent in the case of integrated oil companies (this percentage was increased to 20 percent in 1984). Finally, the expensing of intangible drilling costs in excess of related income is treated as a preference item for purposes of the alternative minimum tax.

It is important to note that this provision does not apply to the cost of unsuccessful drilling or exploration. Even under normal accounting and tax rules the costs incurred in drilling a dry hole would be eligible for immediate deduction at the time of abandonment, since no income-production asset had been developed or improved.

In addition to intangible drilling costs, mining and exploration costs for coal and certain other fuel sources qualify for expensing, subject to separate recapture rules (see description of these provisions below).

Rationale

The tax expenditure for intangible drilling costs was originally established through regulations issued in 1916, with the rationale that such intangible costs were ordinary operating expenses. In 1942 the Treasury recommended that the provisions be removed, but the Congress did not take action. Then, in 1945, a court decision invalidated the rules. In response, the Congress specifically built the provision into the 1954 tax law. Legislative history indicates that the justification for this provision was that it reduced uncertainty and thereby stimulated additional mineral exploration.

The at risk, recapture, and minimum tax restrictions that have since been placed on the use of the provision have primarily limited the ability of high-income taxpayers to shelter their income from taxation through investment in mineral exploration.

Selected Bibliography

Brannon, Gerard M. *Energy Taxes and Subsidies.* Cambridge, Mass.: Ballinger Publishing Co., 1974: 25–45.

———. "Existing Tax Differentials and Subsidies Relating to the Energy Industries," in: Gerard M. Brannon, ed. *Studies in Energy Tax Policy.* Cambridge, Mass.: Ballinger Publishing Co., 1975: 3–40.

Breeding, Clark W., Frank M. Burke and A. Gordon Burton. *Income Taxation of Natural Resources.* Englewood Cliffs, N.J.: Prentice-Hall, Inc., 1977.

Cox, James C. and Arthur W. Wright. "The Cost Effectiveness of Federal Tax Subsidies for Petroleum Reserves: Some Empirical Results and Their Implications," in: Gerard M. Brannon, ed. *Studies in Energy Tax Policy.* Cambridge, Mass.: Ballinger Publisher Co., 1975: 177–197.

Guerin, Sanford M. "Oil and Gas Taxation: A Study in Reform." Denver Law Journal, v. 56, winter 1979: 127–177.

Muscelli, Leonard W. "The Taxation of Geothermal Energy Resources." Law and Water Review, v. 19, No. 1, 1984: 25-41.

U.S. Congress. Congressional Budget Office. "Energy Tax Expenditures: A Compendium." Staff Memorandum, Aug. 7, 1981.

———. House. Committee on Ways and Means. *Tax treatment of Producers of Oil and Gas.* Hearings. 98th Cong., 1st sess., May 5 and 6, 1983.

———. Joint Committee on Taxation. *Description of Energy Tax Bills (S. 1193, S. 1237, S. 1303 and S. 1305),* July 15, 1983.

———. *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984.* Dec. 31, 1984: 726-736.

Senate. Committee on Finance. *Miscellaneous Energy and Agricultural Tax Bills.* Hearing. July 18, 1983.

U.S. Department of Energy. Energy Information Administration. "A Taxonomy of Energy Taxes." *Energy Policy Study,* v. 7, Oct. 1979.

U.S. National Research Council. Committee on Energy Taxation. Assembly of Behavioral and Social Sciences. "Energy Taxation: An Analysis of Selected Taxes." Washington, D.C.: U.S. Energy Information Administration, 1980. (U.S. Department of Energy, Energy Policy Study, v. 14.)

(270) Energy

EXCESS OF PERCENTAGE OVER COST DEPLETION: OIL, GAS, AND OTHER FUELS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals		Corporations		Total	
	Oil and gas	Other fuels	Oil and gas	Other fuels	Oil and gas	Other fuels
1986...	1.0	(1)	0.3	0.3	1.3	0.3
1987...	.6	(1)	.1	.3	.7	.3
1988...	.6	(1)	.1	.3	.7	.3
1989...	.6	(1)	.2	.3	.8	.3
1990...	.6	(1)	.2	.3	.8	.3
1991...	.7	....	.2	.3	.9	.3

[1] Less than $50 million.

Authorization

Sections 613 and 613A and section 291 of the Internal Revenue Code of 1954, as most recently amended by sections 25 and 71 of Public Law 98-369 (Deficit Reduction Act of 1984).

Description

Firms engaged in oil, gas, and other mineral extraction are permitted to deduct a "depletion" allowance against their income each year to reflect the physical and economic depletion of the mineral reserve as the mineral is recovered. There are two methods of calculating this deduction: cost depletion and percentage depletion. Cost depletion, following normal accounting practices, allows for the recovery of initial costs of discovering, purchasing, and developing a mineral reserve over the period during which the reserve produces income. Each year, the taxpayer can deduct a portion of this original cost equal to the fraction of the reserve which has been extracted. Strictly, the deduction equals the adjusted basis (the original cost minus previous deductions) times the ratio of the current year's production to estimated remaining recoverable reserves. Using this method, the cost recovered through depletion allowances cannot exceed the original cost of acquiring the reserve.

Under percentage depletion, a taxpayer deducts a fixed percentage of gross income from mining as a depletion allowance, regardless of the amount invested in the process. The deduction for oil and gas (27.5 percent from 1926 through 1969) was phased down to

15 percent in 1984 and thereafter. Beginning in 1975 the percentage depletion allowance was repealed for major oil and gas companies. Those companies producing less than 50,000 barrels per day (independents) are exempted from repeal for up to 1,000 barrels of oil, or its equivalent in gas, per day. In addition, regulated natural gas and gas sold under a fixed contract remains eligible for percentage depletion at a rate of 22 percent and geopressured methane gas is allowed a 10-percent depletion rate. Once transferred, proved reserves are not eligible for percentage depletion.

Percentage depletion may not exceed 50 percent of the net income from a particular property in any 1 year. This ceiling is known as the net income limitation. Moreover, independents face an additional cap of 65 percent of their overall taxable income (per taxpayer rather than per property). There is no limit, however, on the cumulative amount that can be deducted under percentage depletion.

Percentage depletion also applies to other minerals at rates currently ranging from 22 percent to 5 percent. Uranium qualifies for a 22-percent depletion allowance, coal for a 10-percent allowance, and oil shale for a 15-percent allowance. Geothermal deposits were permitted a 22-percent depletion allowance in 1980, but the rate was scaled down to 15 percent for 1984 and thereafter. Also, under the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), percentage depletion of coal and iron ore properties, in excess of the adjusted basis of such properties, was reduced by 15 percent. Nevertheless, close to 80 percent of the total fuels (as opposed to exploration) revenue loss is a result, in an average year, of oil and gas depletion. The value of this expenditure to the taxpayer is the amount of tax savings that results from using the percentage depletion method instead of the cost depletion method.

Percentage depletion in excess of basis is also treated as a preference item for purposes of the individual and corporate minumum taxes.

Impact

Since the 1975 legislation repealed the percentage depletion allowance for most oil and gas production, only one-quarter of oil and gas production is estimated to be currently eligible for percentage depletion. Percentage depletion for other mineral deposits was unaffected by the 1975 legislation.

Percentage depletion has three types of effects. It (1) decreases the price of qualifying oil, gas, and other minerals and therefore encourages their consumption; (2) bids up the price of drilling and mining rights; and (3) encourages the development of new deposits and increases production. Which of these effects predominates determines who captures the largest share of the subsidy: consumers, landowners, or producers.

The reduction in the effective tax rate of mineral producers from the percentage depletion allowance is dependent on many factors, including the statutory percentage depletion rate and the effect of the net income limitation. For example, the net income limitation for many years kept the effective percentage depletion rate for coal at around 6 percent although the statutory rate is 10 percent.

When the price of oil increased, coal was substituted for oil, resulting in dramatic increases in the price of coal. These coal price increases made the net income limitation inapplicable to much coal production, so the effective depletion rate more nearly approached the 10 percent statutory rate.

The combination of this subsidy and the deduction of intangible drilling costs represents a significant boon to mineral producers who are eligible for both. This capital cost recovery system for oil and gas can result in large negative effective tax rates for many producers. Three-quarters of the original investment can be "written off" immediately, and then a portion of gross revenues can be written off for the life of the investment. It is possible for cumulative depletion allowances to total many times the amount of the original investment.

Rationale

Deductions in excess of depletion based on cost were first allowed in 1918 in the form of "discovery value depletion," which allowed depletion on the market value of the deposit after discovery rather than on its cost. The purpose was to stimulate exploration during wartime and to relieve the tax burdens of small-scale producers. However, the Treasury believed that under this system taxpayers often established high discovery values, and thus claimed overstated depletion. In 1926, to avoid the administrative problems raised by the need to establish true market value, Congress substituted percentage depletion for oil and gas properties. Beginning in 1932, percentage depletion was extended to most other minerals.

In 1950, President Truman recommended the reduction of percentage depletion to a maximum of 15 percent, but Congress failed to take action on the recommendation. Only minor changes were made until 1969, when the depletion allowance for oil and gas was reduced from 27.5 percent to 22 percent, and "excess" depletion was made subject to the minimum tax starting in 1970. Substantial changes were made in the Tax Reduction Act of 1975 after the price of oil skyrocketed. Major oil and gas companies were excluded and the rate was phased down to 15 percent for 1984 and thereafter for independent producers.

Selected Bibliography

Anderson, Robert D., Alan S. Miller, and Richard D. Spiegelman. "U.S. Federal Tax Policy: The Evolution of Percentage Depletion for Minerals." Resources Policy, v. 3, Sept. 1977: 165–176.

Brannon, Gerard M. *Energy Taxes and Subsidies.* Cambridge, Mass.: Ballinger Publishing Co., 1975: 23–45.

———. "Existing Tax Differentials and Subsidies Relating to the Energy Industries," in: Gerard M. Brannon, ed. *Studies in Energy Tax Policy.* Cambridge, Mass.: Ballinger Publishing Co., 1975: 3–40.

Breeding, Clark W., Frank M. Burke, and A. Gordon Burton. *Income Taxation of Natural Resources.* Englewood Cliffs, N.J.: Prentice-Hall, Inc., 1977.

Cox, James C. and Arthur W. Wright. "The Cost Effectiveness of Federal Tax Subsidies for Petroleum Reserves: Some Empirical Results and Their Implications," in: Gerard M. Brannon, ed. *Studies* *in Energy Tax Policy*. Cambridge, Mass.: Ballinger Publishing Co., 1975: 177-197.

Daorin, L. and M. Kennedy. "The Taxation of International Oil Production." National Tax Journal, v. 38, Mar. 1985: 81-95.

Davidson, Paul. "The Depletion Allowance Revisited." Natural Resources Journal, v. 10, Jan. 1970: 1-9.

Englebrecht, Ted D. and Richard W. Hutchinson. "Percentage Depletion Deductions for Oil and Gas Operations: A Review and Analysis." Taxes, v. 56, Jan. 1978: 48-63.

Fambrough, Judon. "Taxation of Oil and Gas Payments Based on Production." Oil & Gas Tax Q., v. 32, Dec. 1983: 106-118.

Gravelle, Jane G. Tax Provisions and Effective Tax Rates in the Oil and Gas Industry." Multilith No. 78-68E. Washington, D.C.: The Library of Congress, Congressional Reserch Service, Nov. 3, 1977.

Guerin, Sanford M. "Oil and Gas Taxation: A Study in Reform." Denver Law Journal, v. 56, winter 1979: 127-177.

Harberger, Arnold G. *Taxation and Welfare*. Chicago: University of Chicago Press, 1974: 218-226.

Hassell, Leonard R. "Benefits of Percentage Depletion Modified Somewhat by Tax Reform Act of 1976." Taxation for Accountants, v. 18, Jan. 1977: 36-39.

McCabe, John J. and Charles Webb. "Investment in Solid Mineral Mines Produces Depletion Deductions and Other Tax Benefits." Taxation for Accountants, v. 26, Feb. 1981: 104-110.

McDonald, Stephen L. "U.S. Depletion Policy: Some Changes and Likely Effects." Energy Policy, v. 4, Mar. 1976: 56-62.

Menaker, Mitchell E. "New Law Allows Percentage Depletion After Sec. 351 Transfer of Oil and Gas." Journal of Taxation, v. 54, Mar. 1981: 178-182.

Packer, Michael B. "Percentage Depletion for Geothermal Energy: An Alternative Method for Calculation of Gross Income." Land and Water Law Review, v. 15, No. 2, 1980: 427-443.

Randall, Gory. "Hard Mineral Taxation—Practical Problems." Idaho Law Review, v. 19, summer 1983: 487-503.

Tannenwald, Robert. "Analysis and Evaluation of Arguments for and Against Percentage Depletion." Multilith No. 78-68E. Washington, D.C.: The Library of Congress, Congressional Research Service, Mar. 22, 1978.

U.S. Congress. Congressional Budget Office. "Energy Tax Expenditures: A Compendium." Staff Memorandum, Aug. 17, 1981.

———. Joint Committee on Taxation. *Description of Energy Tax Bills (S. 1193, S. 1237, S. 1303 and S. 1305)*. Committee Print. 98th Cong., 1st sess., July 15, 1983.

———. *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984*. Committee Print. 98th Cong., 2d sess., Dec. 31, 1984: 27-30, 211-216.

———. Senate. Committee on Finance. *Miscellaneous Energy and Agricultural Tax Bills*. Hearing. July 18, 1983.

———. *Tax treatment of Producers of Oil and Gas*. Hearings. 98th Cong., 1st sess., May 5 and 6, 1983.

———. Committee on Interior and Insular Affairs. *An Analysis of the Federal Tax Treatment of Oil and Gas and Some Policy Alternatives*. Committee Print. 93rd Cong., 2d sess., 1974.

U.S. Department of Energy. Energy Information Administration. *A Taxonomy of Energy Policy Study,* v. 7, Oct. 1979. Washington, D.C., 1979.

U.S. National Research Council. Committee on Energy Taxation. Assembly of Behaviorial and Social Sciences. "Energy Taxation: An Analysis of Selected Taxes." Washington, D.C.: U.S. Energy Information Administration, 1980. (U.S. Department of Energy. *Energy Policy Study,* v. 14.)

CAPITAL GAINS TREATMENT OF ROYALTIES FROM COAL

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	0.1	(1)	0.1
1987	.1	(1)	.1
1988	.1	(1)	.1
1989	.1	(1)	.1
1990	.1	(1)	.1
1991	.1	(1)	.1

[1] Less than $50 million.

Authorization

Sections 1231(b) and 631(c) of the Internal Revenue Code of 1954, as most recently amended by sections 178 and 1001 of Public Law 98-369 (Deficit Reduction Act of 1984).

Description

Owners of coal mining rights who lease their property typically retain an economic interest in production through royalties on the mined coal. If the coal is held for more than 6 months prior to disposition (i.e., mining), the lessor may treat these royalties as capital gains rather than as ordinary income. In such cases, percentage depletion is not available to the lessor.

The Deficit Reduction Act of 1984 denied capital gain treatment for disposal of coal to a related party, or to a party subject to common ownership control with the party disposing of the coal. This change applies generally to coal mined after September 30, 1985, subject to transitional rules.

Impact

The extent to which this provision results in tax savings—thereby encouraging leasing and subsidizing production—depends on how the benefits from capital gains treatment compare with those from percentage depletion.

In past years, percentage depletion on coal has often been large enough relative to profits to subject many corporations to the net income limitation which limits percentage depletion to 50 percent of net income. A depletion allowance equal to 50 percent of net income reduces a corporation's marginal tax rate to 23 percent (one-half of 46 percent), whereas capital gains treatment results in a 28-percent tax rate. However, if a taxpayer has a high basis for calculating cost depletion (which can be claimed as an offset to capital gains), the election of cost depletion together with capital gains treatment of royalties may result in a lower tax. Similarly, if the percentage depletion deduction is less than the net income limitation, capital gains treatment may be preferred. The 15-percent cutback on percentage depletion in excess of adjusted basis, under the corporate tax preference rules enacted in 1982, may further increase the attractiveness of capital gain treatment for corporations.

For individuals, the capital gains treatment will usually yield higher tax savings than percentage depletion. Individuals may deduct 60 percent of the amount of any net capital gain from their gross income. The remaining 40 percent is subject to tax according to their normal rate. Thus, a taxpayer in the 50 percent tax bracket pays an effective tax rate on capital gains of 20 percent (0.40 × 0.50).

Assuming that coal prices continue to rise (as they have gradually in recent years), the percentage depletion allowance will be less likely to reduce tax rates by the full 50 percent of net income. The value of newly purchased coal deposits also will be likely to rise, which would increase the value of cost depletion. As a consequence, capital gains treatment will become relatively more valuable to both corporations and individuals. Also assuming increased prices, the industry's need for these benefits will probably decline, as higher prices encourage increases in coal production. The 1984 legislative changes prevent the use of related party royalties as a method for reducing tax on coal operations; however, the benefits of capital gain treatment remain available in other cases.

RATIONALE

Capital gains treatment of coal royalties was adopted in the Revenue Act of 1951. The legislative history suggests that it was adopted to: (1) extend the same treatment to coal lessors as that allowed to timber lessors; (2) provide benefits to long-term lessors with low royalty rates who were unlikely to benefit significantly from the percentage depletion deduction; and (3) encourage the leasing and production of coal.

SELECTED BIBLIOGRAPHY

Agria, Susan. "Special Tax Treatment of Mineral Industries," in: Arnold C. Harberger and Martin J. Bailey, eds. *The Taxation of Income From Capital.* Washington, D.C.: The Brookings Institution, 1969: 77–122.

Breeding, Clark W., Frank M. Burke, and A. Gordon Burton. *Income Taxation of Natural Resources.* Englewood Cliffs, N.J.: Prentice-Hall, Inc., 1977.

Chapman, Duane. "Federal Tax Incentives Affecting Coal and Nuclear Power Economics." Natural Resources Journal, v. 22, 1982: 361–378.

Conrad, Robert F. "Mining Taxation: A Numerical Introduction." National Tax Journal, v. 33, Dec. 1980: 443–449.

Henshaw, Harry P., III. "An Analysis of the Tax Planning Opportunities Unique to the Mining of Coal." Journal of Taxation, v. 53, Dec. 1980: 357–361.

U.S. Congress. Congressional Budget Office. "Energy Tax Expenditures: A Compendium." Staff Memorandum, Aug. 17, 1981.

———. Joint Committee on Taxation. *Business Energy Tax Credits for Conservation and Conversion.* Committee Print. June 9, 1977.

———. *General Explanation of the Crude Oil Windfall Profit Tax Act of 1980 (H.R. 3919, 96th Cong., P.L. 96–223),* 1980.

———. Senate. Committee on Finance. *Targeted Extension of Energy Tax Credits.* Hearings. 98th Cong., 1st sess., on S. 1396. June 17, 1983.

U.S. Department of Energy. Energy Information Administration. "A Taxonomy of Energy Taxes." *Energy Policy Study,* v. 7, Oct. 1979.

———. "Selected Federal Tax and Non-Tax Subsidies for Energy Use and Production," Jan. 1980.

U.S. National Research Council. Committee on Energy Taxation. Assembly of Behavioral and Social Sciences. "Energy Taxation: An Analysis of Selected Taxes." Washington, D.C.: U.S. Energy Information Administration, 1980. (U.S. Department of Energy. *Energy Policy Study,* v. 14.)

Wishart, Ronald S. *Industrial Energy Conservation:* "Records Are Made To Be Broken." Paper prepared for the Seminar-Workshop of the National Institute of Building Sciences, Washington, D.C., May 14, 1981.

(270) Energy

ALTERNATIVE FUEL PRODUCTION CREDIT

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986		(1)	(1)
1987		(1)	(1)
1988		(1)	(1)
1989		(1)	(1)
1990		(1)	(1)
1991		(1)	(1)

[1] Less than $50 million.

Authorization

Section 29 (formerly section 44D) of the Internal Revenue Code of 1954. The credits expire on December 31, 2000.

Description

The Crude Oil Windfall Profit Tax Act of 1980 established a production tax credit of $3 per barrel of oil—equivalent for several forms of alternative fuels. With certain delineated exceptions, the credit was to take effect if the price of oil fell to below $29.50 per barrel and phase in gradually until the price reached $23.50, with both the credit and the phase-in range being adjusted for inflation to 1979 levels. Because the current oil price is below the $23.50 figure as adjusted for post-1979 inflation, the credits are now fully in effect. Qualifying fuels eligible for the credit include oil produced from shale and tar sands, gas produced from geopressured brine, Devonian shale, coal seams, a tight formation, or biomass, and synthetic fuels produced from coal. The credit is offset by any benefits received from Government grants, subsidized or tax-exempt financing, or energy investment credits.

Impact

The drop in the price of oil since 1980 has enabled the credit to have a substantial impact when alternative fuels are produced. However, that same price drop has made production of such fuels less economically attractive.

Rationale

As one part of a multifaceted approach to meeting the Nation's future energy needs, the Congress made a serious commitment to synthetic fuels production in 1980. Alongside the direct spending and loan programs established in the Energy Security Act (Public Law 96-294) and administered by the Synthetic Fuels Corporation, the Windfall Profit Tax legislation included these production credits.

The purpose of the credits was to reduce marketplace uncertainty (by absorbing some of the price fluctuations below a specified floor) and thereby ease access to capital. The Congress was aware that the price of oil would be too high for most of the credits by the time the legislation took effect and intended them to serve "only as protection for producers of alternative fuels against oil price reductions." Since 1980, just such a reduction in prices has in fact taken place; however, the credits may not be adequate to compensate for the reduced production incentives, and reduced profits, which result from such reductions.

Further Comment

The production tax credit was but one of several Federal subsidies and incentives established by the Congress for synthetic fuel production in a period of energy shortage. It can be argued that, in the current environment of high supplies and lower prices, such subsidies are no longer necessary. However, reduced prices may also make subsidies even more necessary if alternative forms of production are to be developed for the future.

If a subsidy is considered desirable, it can be argued that a direct grant approach is more efficient than tax subsidies.

Selected Bibliography

Friedmann, Peter A. and David G. Mayer. "Energy Tax Credits in the Energy Tax Act of 1978 and the Crude Oil Windfall Profit Tax Act of 1980." Harvard Journal on Legislation, v. 17, summer 1980: 465-504.

Lazzari, Salvatore. "The Effects of Federal Tax Policy of Energy Resources: A Comparative Analysis of Oil/Gas and Synthetic Fuels." Multilith No. 83-231. Washington, D.C.: Library of Congress, Congressional Research Service, Dec. 30, 1983.

———. "Federal Tax Provisions Relating to Alcohol Fuels, Including Recent Changes Under the Tax Reform Act of 1984." Multilith No. 84-194. Washington, D.C.: Library of Congress, Congressional Research Service, Nov. 6, 1984.

Shurtz, Nancy E. "Promoting Alcohol Fuels Production: Tax Expenditure? Direct Expenditures? No Expenditures?" Southwestern Law Journal, v. 36, June 1982: 597-644.

U.S. Congress. Congressional Budget Office. "Energy Tax Expenditures: A Compendium." Staff Memorandum, Aug. 17, 1981.

———. Joint Committee on Taxation. *General Explanation of the Crude Oil Windfall Profit Tax Act of 1980,* 96th Cong., 1st sess., 1979: 80-84.

———. *General Explanation of the Crude Oil Windfall Profit Tax Act of 1980,* 96th Cong., 2nd sess., 1980: 80–84.

———. Senate. Committee on the Budget. *Synthetic Fuels.* Hearing. 96th Cong., 1st sess., 1979: 23–24, 55–148.

U.S. Office of Technology Assessment. *Energy from Biological Processes,* July 1980.

(270) Energy

ALCOHOL FUEL CREDIT

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	(1)	(1)	(1)
1987	(1)	(1)	(1)
1988	(1)	(1)	(1)
1989	(1)	0.2	0.2
1990	(1)	.3	.3
1991	(1)	.3	.3

[1] Less than $50 million.

Authorization

The alcohol fuels production credit is authorized in sections 40 and 87 of the Internal Revenue Code of 1954. It expires on December 31, 1992, and no carryforward of unused credits may be made to a year beginning after 1994. Exemptions from motor fuels excise taxes are authorized in sections 4041 and 4081 of the Code for qualified alcohol fuels mixtures and in section 4041 certain alcohol fuels at least 85 percent pure. The exemptions remain in effect through December 31, 1992.

Description

The alcohol fuel tax credit and excise tax exemption work together to subsidize the production and use of alcohol fuels of a type suitable for use in an internal combustion engine. Since the exemptions are the same for all fuels of at least 10 percent alcohol, the credit is needed to provide the same proportional benefits to producers of alcohol for mixed fuels that include more than 10 percent alcohol.

When the fuel is more than 10 percent alcohol, it qualifies for a tax credit (based on the volume and proof of alcohol it contains) as well as the excise tax exemption. However, the credit is reduced by the amount of excise tax exemption applicable to the fuel, thereby making the tax benefit on a per-gallon-of-alcohol basis the same for fuels that are 10 percent alcohol and fuels that are over 10 percent alcohol. The credit is 40 cents per gallon of alcohol of at least 190 proof and 30 cents per gallon of alcohol between 150 and 190 proof.

If a blended mixture of alcohol and gasoline is sold for use as fuel in a trade or business, the producer qualifies for the credit.

Where straight alcohol is used, on the other hand, the credit is available to the consumer, or, if sold at retail, to the seller. Any credits not used in the taxable year in which they are earned may be carried forward up to 7 years.

The Code exempts qualified alcohol fuels mixtures (e.g., gasohol) from the 65-cents-per-gallon Federal excise taxes on gasoline, diesel fuel, and other motor fuels, provided the fuels mixture is at least 10 percent alcohol. The exemptions thus grant a 60-cents-per-gallon subsidy to alcohol producers. Alcohol produced from oil, natural gas, or coal does not qualify for these exemptions.

A 9-cents-per-gallon exemption from the excise tax on special motor fuels is provided for certain neat alcohol fuels derived from sources other than petroleum or natural gas. The exemption is 4½ cents per gallon in the case of such fuels derived from natural gas. Neat alcohol fuels are fuels comprised of at least 85 percent methanol, ethanol, or other alcohol.

Impact

Although alcohol fuels may become a major synthetic fuel source in the future, at present they are not competitive with gasoline on a before-tax basis. Alcohol fuel is not only higher in price, but also requires substantial energy to produce, thereby diminishing the net overall conservation effect. In addition, the production of alcohol fuel from corn and other feed grains increases the demand for these grains, leading to increases in price and the possibility of future shortages. The strategic value of being able to quickly reduce petroleum consumption, however, may be important.

Rationale

The credit and excise tax exemptions were enacted to encourage production and use of alcohol fuels in order to extend the supply of liquid fuels and to reduce the reliance of the United States on imported petroleum.

Selected Bibliography

Friedmann, Peter A. and David G. Mayer. "Energy Tax Credit in the Energy Tax Act of 1978 and the Crude Oil Windfall Profits Tax Act of 1980." Harvard Journal on Legislation, v. 17, summer 1980: 465–504.

Lazzari, Salvatore. *The Effects of Federal Tax Policy on the Development of Energy Resources: A Comparative Analysis of Oil/Gas and Synthetic Fuels.* Multilith No. 83-231. Washington, D.C.: Library of Congress, Congressional Research Service, Dec. 30, 1983.

———. *Federal Tax Provisions Relating to the Tax Reform Act of 1984.* Multilith No. 84-194. Washington, D.C.: Library of Congress, Congressional Research Service, Nov. 6, 1984.

U.S. Congress. Congressional Budget Office. "Energy Tax Expenditures: A Compendium." Staff Memorandum, Aug. 17, 1981.

———. House. Committee on Ways and Means. *Tax Incentives for the Production and Use of Ethanol Fuels.* Hearings. 98th Cong., 2nd sess. Washington: GPO, July 9, 1984: 283.

———. Joint Committee on Taxation. *General Explanation of the Crude Oil Windfall Profit Tax Act of 1980 (H.R. 3919, 96th Cong., P.L. 96-233)*, 1980: 85–97.

U.S. Department of Energy. *The Report of the Alcohol Fuels Policy Review*, June 1979.

U.S. National Alcohol Fuels Commission. *Alcohol Fuels Tax Incentives*, 1980.

U.S. Office of Technology Assessment. *Energy from Biological Processes*, July 1980.

EXCLUSION OF INTEREST ON STATE AND LOCAL GOVERNMENT INDUSTRIAL DEVELOPMENT BONDS FOR ENERGY PRODUCTION FACILITIES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	0.1	0.1	0.2
1987	.3	(1)	.3
1988	.3	(1)	.3
1989	.3	(1)	.3
1990	.3	(1)	.3
1991	.3	(1)	....

[1] Less than $50 million.

Authorization

Section 103 of the Internal Revenue Code of 1954, as most recently amended by Title VI of Public Law 98-369 (Deficit Reduction Act of 1984).

Description

This tax expenditure is two separate provisions which were enacted in 1980, each extending the types of State and local government bonds which are eligible for Federal income tax exemption on their interest income. The first, and largest in terms of lost revenue, exempts interest on industrial development bonds (IDB's) used to finance State or local government-owned, independently operated, small-scale hydroelectric facilities. The portion of a facility eligible for financing by tax-exempt IDB's declines from 100 percent at a facility of 25 megawatts or less to zero for a facility at the upper limit of 125 MW's. This provision is scheduled to expire on January 1, 1986.

Under the second provision, steam-generating plants where at least 50 percent of the fuel is solid waste or derived from waste facilities, owned and operated by a State-authorized governmental facility that produces alcohol for use as a fuel from solid waste or a derived feedstock, and other solid waste energy plants, also are eligible for tax-exempt financing under certain circumstances.

Under the Deficit Reduction Act of 1984, IDB's for both categories of facilities are subject to the volume limitation for all private activity tax-exempt bonds. The amount of all such bonds which may be issued in a State during any given year may not exceed the greater of (1) $150 for each resident of the State, or (2) $200 million.

Impact

IDB's have been issued rarely for these purposes since the provisions were enacted.

Rationale

Interest on IDB's for both the small-scale hydroelectric plants and the State-authorized renewable energy programs was made exempt in order to provide the same benefits to States and localities that other sections of the Windfall Profit Tax Act had provided in the form of tax credits to private taxpayers. Congress expanded the definition of eligible solid waste disposal facilities because the then existing Treasury regulations were felt to deny tax-exempt financing for many of the most technologically efficient methods of converting waste into energy.

Selected Bibliography

Lazzari, Salvatore. "Federal Tax Provisions Relating to Alcohol Fuels Including Recent Changes Under the Tax Reform Act of 1984." Multilith No. 84-194. Washington, D.C.: Library of Congress, Congressional Research Service, Nov. 6, 1984.

Montgomerie, Bruce M. "Federal Income Tax Incentives for the Development and Use of Alternative Energy Sources." Natural Resources Lawyer, v. 14, No. 2, 1981: 339-378.

U.S. Congress. Joint Committee on Taxation. *General Explanation of the Crude Oil Windfall Profit Tax Act of 1980,* 96th Cong., 2nd sess., 1980.

———. *General Explanation of the Revenue Act of 1978,* Mar. 12, 1979: 176-177.

(270) Energy

RESIDENTIAL ENERGY CREDITS: SUPPLY INCENTIVES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	0.6		0.6
1987	.1		.1
1988			
1989			
1990			

Authorization

Section 23 of the Internal Revenue Code of 1954. This credit expired on December 31, 1985 and had not been reinstated by publication date.

Description

The first $10,000 of investment in residential renewable energy source equipment is eligible for a 40-percent tax credit. The $10,000 ceiling applies to cumulative expenditures over the entire period for which the credit is in effect. The credit is available to homeowners and renters. The credits expire December 31, 1985, but unused credits may be carried over for 2 additional years.

"Renewable energy source equipment" is defined as equipment which transmits or uses solar, wind, or geothermal energy for heating and cooling for providing hot water or electricity in a principal residence. Also eligible are expenditures for related labor costs and for the drilling of an onsite well for a geothermal deposit, provided that the deduction for intangible drilling costs has not been taken. Passive solar systems are ineligible for this credit to the extent that they constitute structural modifications.

The credit is not available for expenditures which are also financed by tax-exempt grants or federally subsidized energy financing.

Impact

Lack of information and seemingly long payback periods appear to be the most significant barriers to this type of investment. The credit shortened the time period required to recoup initial expenditures and the congressional action helps to increase public awareness of these technologies. However, initial response to the credit was sluggish. As expected, almost all (96 percent) of the credit taken in 1978 went toward investments in solar heating and hot water systems. In 1980, Congress decided to increase the credit to strengthen its incentive. It still has not been determined whether these credits have had an impact or whether higher energy prices alone are a sufficient incentive to encourage such investments.

In addition to the Federal conservation and solar tax credits, there are many State financial incentives. The most widely adopted measure is the exemption of solar systems from inclusion in the value of property for tax purposes. Several States have income tax deductions and more than 20 States provided an income tax credit ranging from 5 to 55 percent. Together with the 40 percent Federal credit (most State credits may be claimed on top of the Federal credit), these incentives may have considerable impact.

Rationale

The renewable energy source credits were enacted as part of the program to achieve self-sufficiency in energy production by reducing reliance on oil and gas. Although the fuel sources eligible for this credit were already economically practical, their commercialization has been slow. These technologies were particularly appealing because they were perceived to be less hazardous to the environment than coal or nuclear power. In order to give them a boost in the market and to enable them to compete with heavily subsidized conventional fuel sources, the Congress enacted a 30-percent investment credit in the 1978 Energy Tax Act. In 1980, this credit was increased to its present 40 percent.

Selected Bibliography

Bezdek, Roger H. and F. T. Sparrow. "Solar Subsidies and Economic Efficiency." Energy Policy, v. 9, Dec. 1981: 289–299.

Charles River Associates, Inc. *An Analysis of the Residential Energy Conservation Tax Credits: Concepts and Numerical Estimates.* Report No. 486. Oak Ridge, Tenn.: Union Carbide Corp., June 1981.

Davenport, Charles. "The Role of Taxation in the Regulation of Energy Production and Consumption (1978 Energy Act—A Case in Point)." National Tax Journal, v. 31, Sept. 1978: 221–228.

Dawkins, Lisa and George Troutman. "Solar Energy Legislation in the 95th Congress." Solar Law Reporter, v. 1, May–June 1979: 139–155.

Due, John F. "The Tax Aspects of the President's Energy Proposals." Tax Notes, v. 5, June 20, 1977: 11–16.

Friedmann, Peter A. and David G. Mayer. "Energy Tax Credits in the Energy Tax Act of 1978 and the Crude Oil Windfall Profits Tax Act of 1980." Harvard Journal on Legislation, v. 17, summer 1980: 465–504.

Klepper, Martin. "Energy Tax Act of 1978 Brings New Tax Credits for Individuals and Businesses." Journal of Taxation, v. 49, Dec. 1978: 332–336.

McDonald, Stephen L. "The Energy Tax Act of 1978." Natural Resources Journal, v. 19, Oct. 1979: 859-869.

McIntyre, Robert S. "Lesson for Tax Reformers From the History of the Energy Tax Incentives in the Windfall Profit Tax Act of 1980." Boston College Law Review, v. 22, May 1981: 705-745.

Moore, Steven. "A Critique of Insulation and Solar Energy Tax Credit Proposals." Tax Notes, v. 5, Apr. 1977: 15-20.

U.S. Congress. Congressional Budget Office. "Energy Tax Expenditures: A Compendium." Staff Memorandum, Aug. 17, 1981.

———. "President Carter's Energy Proposals: A Perspective." Staff Working Paper, June 1977.

———. Joint Committee on Taxation. "Energy Tax Provisions—2: Residential Tax Credits." Prepared for the Committee on Finance, United States Senate. 1977.

———. House. Conference Committees. *Energy Tax Act of 1978; Conference Report to Accompany H.R. 5263.* 95th Cong., 2d sess., House Report No. 95-1773, 1978.

———. Joint Committee on Taxation. *General Explanation of the Crude Oil Windfall Profit Tax Act of 1980.* 96th Cong., 2d sess., 1980.

U.S. Department of Energy. Energy Information Administration. "A Taxonomy of Energy Taxes." *Energy Policy Study,* v. 7, Oct. 1979.

———. *Selected Federal Tax and Non-Tax Subsidies for Energy Use and Production,* Jan. 1980.

(270) Energy

RESIDENTIAL ENERGY CREDITS: CONSERVATION INCENTIVES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	0.3		0.3
1987			
1988			
1989			
1990			

Authorization

Section 23 of the Internal Revenue Code of 1954. This credit expired on December 31, 1985 and had not been reinstated by publication date.

Description

A 15-percent tax credit is available to homeowners and renters for certain purchases that increase the energy efficiency of their residences. The credit applies to the first $2,000 of qualifying expenditures on each principal residence over the entire period the credit is in effect. Therefore, there is a maximum cumulative credit of $300 for energy-saving expenditures made after April 9, 1977, and before January 1, 1986, provided the residence was substantially completed before April 20, 1977. The credits remain in effect through 1985, and unused credits may be carried over for 2 additional years.

The following items are eligible for the credit: insulation, replacement burners and devices to modify flue openings to increase fuel efficiency, electrical or mechanical furnace ignition systems that replace gas pilot lights, storm or thermal windows or doors, automatic setback thermostats, caulking or weatherstripping, and energy usage meters. The Secretary of the Treasury is empowered to add to the list under the conditions that: (1) the new equipment or technology would result in a reduction in oil or natural gas usage large enough to justify the expenditures; (2) the new equipment or technology would not increase the use of environmentally hazardous or otherwise unsafe items; and (3) the addition to the list would not be unnecessary or inappropriate because of existing Federal subsidies. No additions have yet been made.

To prevent "double dipping" from both tax benefits and direct outlays, the credit is not available insofar as the energy-conserving expenditure was paid for by tax-exempt grants or other subsidized energy financing.

Rationale

Considerable energy savings can be achieved in the residential sector through the application of certain materials, such as insulation. The Congress perceived that there were barriers to the installation of such items; the long length of time necessary to recoup the original investment was one of the most prominent. To reduce this and other obstacles to increased conservation efforts among existing homes, the Congress instituted this credit.

Impact

The tax credit was designed primarily to encourage homeowners to improve the energy efficiency of their residences. The then current rises in energy prices and the growing expectation that they would likely remain high may have obviated much of the need for the subsidy. The current provision may, therefore, be largely providing a windfall for purchases of conservation equipment that would have been made anyway, rather than adding to the total amount or speeding the rate of investment.

Substantial evidence suggests that the largest remaining residential conservation gains are to be had among low-income households. At least 43 percent of such households have no insulation and 58 percent have no storm windows or doors, compared to 17 percent and 39 percent for all households. The credit does not provide an effective subsidy for these households for a variety of reasons: most of them are renters, and the credit is unavailable to landlords; many low-income renters do not have sufficient disposable income to allow them to invest the 85 percent of the cost of insulation not covered by the credit; and, the credit is not refundable.

In addition to the question of appropriate targeting, there are also concerns about the administrative feasibility of the credit. The information needed to determine eligibility for the credit is not normally available on tax returns and the IRS has no easy way of checking whether energy-saving items were actually installed, whether they were of the eligible type, whether they cost as much as the taxpayer claimed, and so on. Abuse of this provision may thus be a problem.

Selected Bibliography

Charles River Associates, Inc. *An Analysis of the Residential Energy Conservation Tax Credits: Concepts and Numerical Estimates.* Report No. 486. Oak Ridge, Tenn.: Union Carbide Corp., June 1981.

Davenport, Charles. "The Role of Taxation in the Regulation of Energy Production and Consumption (1978 Energy Act—A Case in Point)." National Tax Journal, v. 31, Sept. 1978: 221–228.

Due, John F. "The Tax Asspects of the President's Energy Proposals." Tax Notes, v. 5, June 20, 1977: 11–16.

Friedmann, Peter A. and David G. Mayer. "Energy Tax Credits in the Energy Tax Act of 1978 and the Crude Oil Windfall Profit Tax Act of 1980." Harvard Journal on Legislation, v. 17, summer 1980: 465–504.

Hyatt, Sherry V. "Thermal Efficiency and Taxes: The Residential Energy Conservation Tax Credit." Harvard Journal on Legislation, v. 14, Feb. 1977: 281–326.

Klepper, Martin. "Energy Tax Act of 1978 Brings New Tax Credits for Individuals and Businesses." Journal of Taxation, v. 49, Dec. 1978: 332–336.

McDonald, Stephen L. "The Energy Tax Act of 1978." Natural Resources Journal, v. 19, Oct. 1979: 859–869.

McIntyre, Robert S. "Lesson for Tax Reformers From the History of the Energy Tax Incentives in the Windfall Profits Tax Act of 1980." Boston College Law Review, v. 22, May 1981: 705–745.

Moore, Steven. "A Critique of Insulation and Solar Energy Tax Credit Proposals." Tax Notes, v. 5, Apr. 18, 1977: 15–20.

U.S. Congress. Congressional Budget Office. "Energy Tax Expenditures: A Compendium." Staff Memorandum, Aug. 17, 1981.

———. "President Carter's Energy Proposals: A Perspective." Staff working Paper, June 1977.

———. Joint Committee on Taxation. "Energy Tax Provisions—2: Residential Tax Credits." Prepared for the Committee on Finance, United States Senate. 1977.

———. House. Conference Committee. *Energy Tax Act of 1978; Conference Report to Accompany H.R. 5263.* 1978. 95th Cong., 2d sess., House Report No. 95–1773.

———. Joint Committee on Taxation. *General Explanation of the Crude Oil Windfall Profit Tax Act of 1980 (H.R. 3919 96th Cong., P.L. 96–223),* 1980.

———. Office of Technology Assessment. *Residential Energy Conservation,* v. 1, July 1979.

U.S. Department of Energy. Energy Information Administration. "A Taxonomy of Energy Taxes." *Energy Policy Study,* v. 7, Oct. 1979.

———. *Selected Federal Tax and Non-Tax Subsidies for Energy Use and Production,* Jan. 1980.

ALTERNATIVE, CONSERVATION AND NEW TECHNOLOGY CREDITS: SUPPLY INCENTIVES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	[1]	0.1	0.1
1987	[1]	[1]	[1]
1988	[1]	[1]	[1]
1989		[1]	[1]
1990		[1]	[1]

[1] Less than $50 million.

Authorization

Sections 46 and 48 of the Internal Revenue Code of 1954. The credits as enacted generally were to expire on January 1, 1983, but in several instances the Windfall Profit Tax Act extended the expiration date to December 31, 1985. This credit expired on December 31, 1985.

Description

The Energy Tax Act and the Windfall Profit Tax Act included investment tax credits for equipment using alternate sources of energy. Alternative energy is defined as any energy source other than oil, natural gas, or their products (with the exception of petroleum coke and petroleum pitch). The legislation provides a 10-percent, nonrefundable energy investment credit for technology used to burn alternative substances (including biomass) or convert them to synthetic fuel and for equipment used to extract oil from shale rock and natural gas from geopressured brine. The credit may be used against 100 percent of income tax liability.

In addition, the Windfall Profit Tax Act provides a 15-percent, nonrefundable credit for investments in: solar and wind energy equipment used to generate electricity or to provide heating, cooling, hot water or process heat, and technology to produce, distribute, or use geothermal or ocean thermal energy. These credits extend through 1985.

Finally, the 1980 act establishes an 11-percent tax credit for investments in small-scale (capacity less than 125 megawatts) hydroelectric generating facilities. In this case, the fraction of the investment eligible for the credit declines as the generating capacity increases. For example, 100 percent of the investment qualifies for the credit when the capacity is 25 megawatts or less, while only 25 percent qualifies at 100 megawatts. At 125 megawatts the credit is phased out entirely. This provision remains in effect until December 31, 1985, but there is an extension to December 31, 1988 for qualifying investments for which an application has been received before January 1, 1986.

Impact

As with the energy-conservation business tax credits, it is not clear how much these credits encourage additional investment as opposed to subsidizing investment that would have been made anyway. Generally, the need for the tax credits is likely to decline over time as investors' uncertainty about the new technologies is dispelled.

Rationale

The rationale behind the introduction of these credits was primarily to reduce the dependency of the United States on oil and natural gas. In this instance, the strategy was to encourage the use and production of alternative fuels.

The relatively high levels of expense and uncertainty associated with these technologies and various institutional barriers to these investments, combined with the divergence of social benefits from private benefits, prompted the Congress to provide these tax credits as incentives. Due to the sluggish initial response, the credits for renewable energy sources were expanded and extended in the Windfall Profit Tax Act.

Selected Bibliography

Due, John F. "The Tax Aspects of the President's Energy Proposals." Tax Notes, v. 5, June 20, 1977: 11–16.

Friedmann, Peter A. and David G. Mayer. "Energy Tax Credits in the Energy Tax Act of 1978 and the Crude Oil Windfall Profits Tax Act of 1980." Harvard Journal on Legislation, v. 17, summer 1980: 465–504.

Hyatt, Richard J. *Legal and Institutional Implications of Providing Financial Incentives to Encourage the Development of Solar Technologies.* Golden, Col.: U.S. Dept. of Energy, 1979.

Klepper, Martin. "Energy Tax Act of 1978 Brings New Tax Credits for Individuals and Business." Journal of Taxation, v. 49, Dec. 1978: 332–336.

McDonald, Stephen L. "The Energy Tax Act of 1978." Natural Resources Journal, v. 19, Oct. 1979: 859–869.

McIntyre, Robert S. "Lessons for Tax Reformers From the History of the Energy Tax Incentives in the Windfall Profits Tax Act of 1980." Boston College Law Review, v. 22, May 1981: 705–745.

Minan, John H. and William H. Lawrence. "Encouraging Solar Energy Development Through Federal and California Tax Incentives." Hastings Law Journal, v. 32, Sept. 1980: 1–58.

Solar Energy Policy Forum. Chicago, 1978: *Report of Domestic Policy Review on Solar Energy.* Washington, D.C.: U.S. Dept. of Energy, 1978: 54 p.

Torkko, Dennis and Robert W. Zimmerman. "Final Regulations on Business Energy Tax Credits Prove Constricting and Burdensome." Journal of Taxation, v. 54, May 1981: 290–292.

U.S. Congress. Congressional Budget Office. "President Carter's Energy Proposals: A Perspective." Staff Working Paper, June 1977.

———. "Energy Tax Expenditures: A Compendium." Staff Memorandum, Aug. 17, 1981.

———. House. Conference Committees. *Energy Tax Act of 1978; Conference Report to Accompany H.R. 5263.* 95th Cong., 2d sess., House Report No. 95–1773, 1978.

———. Committee on Science and Technology. *Tax Incentives for New Energy Technologies.* Hearings. 98th Cong., 1st sess., July 12, 21, 1983.

———. Joint Committee on Taxation. *General Explanation of the Crude Oil Windfall Profit Tax Act of 1980,* H.R. 3919, 96th Cong., P.L. 96–223, 1980.

———. Senate. Committee on Finance. *Targeted Extension of Energy Tax Credits.* Hearing. 98th Cong., 1st sess., on S. 1396, June 17, 1983.

(270) Energy

ALTERNATIVE ENERGY, CONSERVATION AND NEW TECHNOLOGY CREDITS: CONSERVATION INCENTIVES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	(1)	(1)	(1)
1987	(1)	(1)	(1)
1988	(1)	(1)	(1)
1989			
1990			

[1] Less than $50 million.

Authorization

Sections 46 and 48 of the Internal Revenue Code of 1954. This credit expired on December 31, 1985.

Description

Investments in "specially defined energy property" that increase the energy efficiency of commercial or industrial facilities and processes are eligible for a 10-percent nonrefundable business energy investment credit. Where tax-exempt industrial development bonds are used in the financing, the credit is 5 percent. The energy tax credit may be taken on new equipment that has a useful life of 3 years or more and it may be applied against 100 percent of income tax liability, but it may not exceed the recipient's tax liability. The tax basis of business energy property is reduced by one-half the amount of the energy credit.

Most items which are specially defined energy property reduce energy consumption through the recovery and utilization of waste heat. The list also includes energy-saving modifications made to alumina electrolytic cells and cogeneration equipment where no more than 20 percent of the fuel consumed in the process is oil or natural gas (or their derivatives). It is important to note that while several of these technologies can be used for purposes such as space heating of large buildings, the credit only applies when they are directly integrated into an industrial or commercial process, narrowly defined.

The Windfall Profit Tax Act of 1980 extended the expiration date of these credits from December 31, 1982 to December 31, 1990, in those instances where all engineering studies have been completed and all environmental and construction permits have been applied for before January 1, 1983, and where the taxpayer has entered into binding contracts to acquire and/or construct at least 50 percent of the total estimated value of the project before January 1, 1986.

Impact

The business energy investment credit is aimed at promoting energy conservation by reducing the price of energy-conserving capital to business investors. While the credit provides added, and perhaps sometimes decisive, encouragement to businesses considering such investment, higher energy prices and other market conditions provide the primary incentive.

Rationale

The energy tax credits were aimed at lowering barriers to investment in conservation equipment. Energy-conserving technologies are often more expensive and their future performance may appear uncertain to the potential investor. In addition, the absence of adequate information regarding appropriate technologies inflates the perceived risk and further discounts future benefits. Another barrier is created when firms defer such investments because they believe that opportunities for investment in energy efficiency are always present, while opportunities for achieving other goals may not be.

Congress also recognized the existence of externalities. When the national security impact is taken into account, the payback to society as a whole is greater than the payback to investors, and the level of investment may therefore be less than socially optimal.

Selected Bibliography

Brancato, Carolyn Kay. "Economic Incentives to Increase U.S. Industrial Energy Efficiency." Multilith No. 81-223E. Washington, D.C.: The Library of Congress, Congressional Research Service, Oct. 5, 1981.

Energy and Environmental Analysis, Inc., Arlington, Va. *Analysis of Proposals to Provide Incentives for the Reduction of Oil and Gas Consumption in the Industrial Sector.* Prepared for the U.S. Department of Energy, Office of Industrial Programs, Conservation and Solar Applications Division. Washington, D.C., Oct. 26, 1979.

Friedmann, Peter A. and David G. Mayer. "Energy Tax Credits in the Energy Tax Act of 1978 and the Crude Oil Windfall Profits Tax Act of 1980." Harvard Journal on Legislation, v. 17, summer 1980: 465–504.

Jackson, Jerry R. and William S. Johnson. *Commercial Energy Use: A Disaggregation by Fuel, Building Type, and End Use.* Oak Ridge, Tenn.: Oak Ridge National Laboratories, Feb. 1978 (ORNL/Con–14).

Klepper, Martin. "Energy Tax Act of 1978 Brings New Tax Credits for Individuals and Business." Journal of Taxation, v. 49, Dec. 1978: 332–336.

McDonald, Stephen L. "The Energy Tax Act of 1978." Natural Resources Journal, v. 19, Oct. 1979: 859–869.

McIntyre, Robert S. "Lessons for Tax Reformers From the History of the Energy Tax Incentives in the Windfall Profits Tax Act of 1980." Boston College Law Review, v. 22, May 1981: 705–745.

Torkko, Dennis and Robert W. Zimmerman. "Final Regulations on Business Energy Tax Credits Prove Constricting and Burdensome." Journal of Taxation, v. 54, May 1981: 290–292.

U.S. Congress. Congressional Budget Office. "President Carter's Energy Proposals: A Perspective." Staff Working Paper, June 1977.

———. "Energy Tax Expenditures: A Compendium." Staff Memorandum, Aug. 17, 1981.

———. House. Conference Committee: *Energy Tax Act of 1978; Conference Report to Accompany H.R. 5263,* 1978, 95th Cong., 2d sess., House Report No. 95–1773.

———. Committee on Science and Technology. *Tax Incentives for New Energy Technologies.* Hearings. 98th Cong., 1st sess., July 12, 21, 1983.

———. Joint Committee on Taxation. *Business Energy Tax Credits for Conservation and Conversion.* Committee Print. June 9, 1977.

———. *General Explanation of the Crude Oil Windfall Profits Tax Act of 1980* (H.R. 3919, 96th Cong., P.L. 96–223), 1980.

Senate. Committee on Finance. *Targeted Extension of Energy Tax Credits.* Hearings. 98th Cong., 1st sess. on S. 1396. June 17, 1983.

U.S. Department of Energy. Energy Information Administration. "A Taxonomy of Energy Taxes." *Energy Policy Study,* v. 7, Oct. 1979.

———. "Selected Federal Tax and Non-Tax Subsidies for Energy Use and Production," Jan. 1980.

Wishart, Ronald S. Industrial Energy Conservations: "Records Are Made To Be Broken." Paper prepared for the Seminar-Workshop of the National Institute of Building Sciences, Washington, D.C., May 14, 1981.

(300) Natural Resources and Environment

EXPENSING OF EXPLORATION AND DEVELOPMENT COSTS, NONFUEL MINERALS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	(1)	0.1	0.1
1987	(1)	.1	.1
1988	(1)	.1	.1
1989	(1)	.2	.2
1990	(1)	.2	.2
1991	(1)	.2	.2

[1] Less than $50 million.

Authorization

Sections 263(c), 291, 465, 616-617, 704(d), and 1254 of the Internal Revenue Code of 1954.

Description

Taxpayers engaged in mining activities may deduct exploration and development costs as incurred (i.e., these costs may be expensed).

Mining exploration costs are expenditures for the purpose of ascertaining the existence, location, extent or quality of any deposit of ore or other depletable mineral paid or incurred by the taxpayer prior to the development stage of the mine or deposit. For example, exploration expenditures include amounts paid or incurred to ascertain the existence of a commercially marketable ore deposit. Foreign exploration costs cannot be expensed after the taxpayer has total foreign and domestic exploration costs of $400,000.

Development expenses generally include those incurred for the development of a mine or other natural deposits after the existence of ores in commercially marketable quantities has been determined. Development expenditures generally include those for construction of shafts and tunnels, and in some cases drilling and testing to obtain additional information for planning operations. There are no limits on the current deductibility of such costs. Mine development costs may be taken in addition to percentage depletion. Mining exploration costs subsequently reduce percentage depletion deductions. In the case of mines, there are "recapture" provisions under which capital gains from the sale of the property are treated as ordinary income to the extent of prior deductions for exploration expenses.

The Tax Equity and Fiscal Responsibility Act of 1982 reduced by one-third the deduction by corporations for expensing of mining exploration and development costs and allowed the investment tax credit with respect to such disallowed expenses. Additionally, the expensing of such costs is treated as a preference item for purposes of the individual alternative minimum tax.

Impact

Generally, expenditures that generate assets yielding income over several years must be capitalized and deducted over the period in which the assets produce income. The tax advantage of treating these expenditures as current expenses is the same as any other use of premature deductions: the taxpayer is allowed to defer current tax liabilities; this treatment amounts to an interest-free loan from the Treasury.

These expensing provisions are additional benefits which supplement the special percentage depletion allowances extended to the mineral industry. Although the expensing and depletion provision operate somewhat independently, a firm or person may be eligible for both and receive their combined benefits.

Rationale

Expensing of mine development expenditures was enacted in 1951 to reduce ambiguity in the then existing treatment of, and to encourage, mining. The provision for mine exploration was added in 1966.

Prior to the Tax Reform Act of 1969, a taxpayer could elect either to deduct without dollar limitation exploration expenditures in the United States, which subsequently reduced percentage depletion benefits, or to deduct up to $100,000 a year with a total not to exceed $400,000 of foreign and domestic exploration expenditures without the application of this recapture rule. The 1969 act subjected all post-1969 exploration expenditures to recapture.

Selected Bibliography

Agria, Susan. "Special Tax Treatment of Minerials Industries," in: Arnold C. Harberger and Martin J. Bailey, eds. *The Taxation of Income from Capital.* Washington, D.C.: The Brookings Institution, 1969: 77–122.

Conrad, Robert F. "Mining Taxation: A Numerical Introduction." National Tax Journal, v. 33, Dec. 1980: 443–449.

U.S. Congress. Joint Committee on Taxation. *General Explanation of the Tax Reform Act of 1976,* Dec. 29, 1976: 62–67.

EXCESS OF PERCENTAGE OVER COST DEPLETION, NONFUEL MINERALS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	(1)	0.3	0.3
1987	(1)	.3	.3
1988	(1)	.3	.3
1989	(1)	.3	.3
1990	(1)	.3	.3
1991	(1)	.4	.4

[1] Less than $50 million.

Authorization

Sections 613 and 613A and section 291 of the Internal Revenue Code of 1954.

Description

Most firms engaged in mineral extraction are permitted to deduct a depletion allowance for the exhaustion of the mineral deposits. There are two methods of calculating depletion: percentage depletion and cost depletion. Taxpayers who qualify for percentage depletion must use it if it is greater than cost depletion.

Under percentage depletion, a taxpayer deducts a fixed percentage of gross income from mining as a depletion allowance, regardless of the amount invested in the deposit.

Percentage depletion applies to mineral resources at percentages currently ranging from 22 percent to 5 percent. Sulphur, uranium, and most other metals mined in the United States qualify for the 22 percent rate; however, domestic gold, silver, and iron ore qualify for a 15-percent rate; most minerals mined outside the United States qualify for a 14-percent rate; coal qualifies for a 10-percent rate; and several forms of clay, gravel, and stone qualify for 5 and 7½ percent rates.

Percentage depletion may not exceed 50 percent of the net income from the property. This limitation is known as the net income limitation. The total cost which can be recovered by percentage depletion is not limited to the cost of the property.

Cost depletion resembles depreciation based upon the number of units produced. The share of the original cost deduction each year is equal to the portion of the estimated total production (over the lifetime of the well or mine) which is produced in that year. Using cost depletion, capital recovery cannot exceed the initial cost. The value of the percentage depletion provision to the taxpayer is the amount of tax savings on the excess of the percentage depletion over cost depletion.

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) reduced by 15 (now 20) percent the percentage depletion of coal and iron ore properties in excess of the adjusted basis of such properties. Percentage depletion in excess of basis for all properties is treated as a preference item for purposes of the individual and corporate minimum taxes.

Impact

Issues of principal concern are the extent to which percentage depletion: (1) decreases the price of qualifying minerals, and therefore encourages their consumption; (2) bids up the price of exploration and mining rights; and (3) encourages the development of new deposits and increases production.

Most analyses of percentage depletion have focused on the oil and gas industry, which prior to 1975 accounted for the bulk of percentage depletion. Compared to oil and gas percentage depletion, there has been relatively little analysis of the impact of percentage depletion on other industries. The relative value of the percentage depletion allowance in reducing the effective tax rate of mineral producers is dependent on a number of factors, including the statutory percentage depletion rate and the effect of the net income limitation.

Rationale

Deductions in excess of depletion based on cost were first allowed in 1918 in the form of discovery value depletion which allowed depletion on the market value of the deposit after discovery rather than on its cost. The purpose was to stimulate exploration during wartime and to relieve the tax burdens on small-scale prospectors. However, the Treasury believed that under this system taxpayers often established high discovery values, and thus claimed excessive depletion. In 1926, to avoid the administrative problems raised by the need to establish market value, Congress substituted percentage depletion for oil and gas properties. Beginning in 1932, percentage depletion was extended to most other minerals.

In 1950, President Truman recommended the reduction of percentage depletion to a maximum of 15 percent, but Congress failed to take action on this recommendation. Only minor changes were made until 1969, when the depletion allowance for oil and gas was reduced from 27.5 percent to 22 percent, and excess depletion was made subject to the tax on preference items beginning in 1970.

Selected Bibliography

Agria, Susan. "Special Tax Treatment of Mineral Industries," in: Arnold C. Harberger and Martin J. Bailey, eds. *The Taxation of Income from Capital.* Washington, D.C.: The Brookings Institution, 1969: 77-122.

Anderson, Robert C., Alan S. Miller, and Richard D. Spiegelman. "U.S. Federal Tax Policy: The Evolution of Percentage Depletion for Minerals." Resources Policy, v. 3, Sept. 1977: 165-178.

Conrad, Robert F. "Mining Taxation: A Numerical Introduction." National Tax Journal, v. 33, Dec. 1980: 443-449.

U.S. Congress. Joint Committee on Taxation. *General Explanation of the Tax Reform Act of 1976,* Dec. 29, 1976: 62-67.

Updegraft, Kenneth E. Jr., and Joel D. Zychick. "Transportation of Crude Mineral Production by Mine Owners and Its Effect on Hard Minerals Depletion Allowance." Tax Lawyer, v. 35, winter 1982: 367-387.

Tripp, John D., Hugh D. Grove and Michael McGrath. "Maximizing Percentage Depletion in Solid Minerals." Oil and Gas Tax Quarterly, v. 30, June 1982: 631-646.

CAPITAL GAINS TREATMENT OF CERTAIN TIMBER INCOME

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	0.2	0.6	0.8
1987	.1	.5	.6
1988	.2	.6	.8
1989	.2	.6	.8
1990	.2	.6	.8
1991	.2	.7	.9

Authorization

Sections 631 (a) and (b), 1221 and 1231.

Description

If a taxpayer has held standing timber or the right to cut it for more than 1 year, the taxpayer may elect to treat the cutting of this timber as the sale of a long-term capital asset at a price equal to its fair market value on the first day of the taxable year. If an election is made, gain or loss accruing before the first day of the year in which the cutting occurs is treated as long-term capital gain or loss. Changes in the value of the timber after the first of the year result in ordinary income or loss, and not capital gain or loss. Capital gains treatment also can apply to the sale of a stand of timber and the sale of timber as it is cut by the buyer. Timber includes ornamental evergreens that are 6 years of age or more when severed from the roots.

Impact

The capital gains treatment of the cutting and sale of timber constitutes a departure from the general rule that sale of a taxpayer's inventory yields ordinary income. However, when timber is inventory, it is usually held substantially longer than other types of inventory.

Both individual and corporate taxpayers are eligible for this treatment. The graduated structure of the individual income tax rates makes the provision more beneficial to individuals with high incomes because the value of the deduction for capital gains increases with the marginal income tax rate.

Some of a timber owner's costs which maintain or even arguably improve his trees, such as disease control and thinning costs, can be expensed currently even though their effects may continue beyond the year in which they are made, and though they are related to income which only will be recognized many years in the future. Therefore, timber ownership offers opportunities for some taxpayers to deduct current expenses associated with such ownership against ordinary income from other sources.

Rationale

The sale of a timber stand that had not been held in the course of business was long considered the sale of a capital asset. The Revenue Act of 1943 extends this capital gain treatment to all persons who cut and sell their timber and to those who lease timber stands for cutting. One reason for adopting this provision was to equalize treatment between the taxpayer who sold timber as a stand outright, and the taxpayer who cut timber for use in his business. It was also suggested that this treatment would encourage conservation of timber through selective cutting and that taxing the capital gain at ordinary rates was an unfair practice because of the comparatively long development time of timber.

Selected Bibliography

Briggs, Charles W. and William K. Condrell. *Tax Treatment of Timber.* Forest Industries Committee on Timber Valuation and Taxation, Washington, D.C. 1969.

Gregory, William H. "Timber, Agriculture and Energy—From Christmas Trees to Geothermal." Forty-First Annual Institute on Federal Taxation. New York University, 1983: 32-1—32-32.

Harkleroad, Donald R. "General Federal Tax Principles Relating to Timber Business Expenditures and Depletion Allowance Computation." Agricultural Law Review, v. 4, summer, 1982: 137-152.

Knight, W. Donald, Jr., et al. "Planning for Foreign Investment in U.S. Timberlands." Tax Management International Journal, May 1978: 3-21.

Society of American Foresters, Study Group on Forest Taxation. "Forest Taxation." Journal of Forestry, v. 78, July 1980: 1-7.

Stephens, John J. "The Need for a National Policy on Timber Capital Formation." Forest Farmer, Mar. 1978: 8-9, 15-17.

Sunley, Emil M., Jr. "The Federal Tax Subsidy of the Timber Industry," in: U.S. Congress. Joint Economic Committee. *The Economics of Federal Subsidy Programs,* Part 3—Tax Subsidies, July 15, 1972: 317-342.

U.S. Congress. House Committee on Ways and Means and Senate Committee on Finance. *Tax Reform Studies and Proposals: U.S. Treasury Department.* Committee Print. 91st Cong., 1st sess., Feb. 3, 1969: 434-438.

U.S. Department of Agriculture, Forest Service. *The Timber Owner and His Federal Income Tax.* Agricultural Handbook No. 274, Revised July 1975. Washington, D.C: U.S. Government Printing Office.

(300) Natural Resources and Environment

MENT CREDIT AND 7-YEAR AMORTIZA-
FOR REFORESTATION EXPENDITURES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	([1])	0.1	0.1
1987	([1])	.1	.1
1988	([1])	.1	.1
1989	([1])	.1	.1
1990	([1])	.1	.1
1991	([1])	.1	.1

[1] Less than $50 million.

Authorization

ns 48 and 194 of the Internal Revenue Code of 1954.

Description

payer may elect to amortize, over a 7-year period, up to
of qualifying reforestation expenditures incurred during a
year in connection with the commercial production of
Qualifying expenditures are the direct costs incurred to
seed for forestation or reforestation purposes, including
site preparation, seed or seedlings, and labor and tool
cluding depreciation on equipment used for this purpose).
which the taxpayer has been reimbursed under a govern-
ost-sharing program generally are excluded. Costs that are
le currently also are excluded. These amortization deduc-
taken in computing adjusted gross income. Costs in excess
0 in any taxable year may not be carried over to succeed-
s. A mandatory half-year convention is provided.

-percent investment tax credit is allowed for reforestation
gible for the amortization election, regardless of whether
tion treatment is elected. The same annual limitation ap-
d there is no carryover of excess qualifying costs. The in-
t credit under these provisions may not be claimed for
g reforestation expenditures that otherwise qualify for the
s, for example, depreciation on equipment used for refor-
that already qualifies for the regular investment credit).

Impact

Before enactment of these provisions, reforestation costs were treated as capital expenditures, to be recovered when the timber was harvested and did not qualify for the investment credit. The provisions thus extended to reforestation expenditures special treatment that departs from the general requirement of matching expenditures and income and the distinction between investment and capitalized expenditures.

Rationale

The reason for the provisions as stated by the conference committee was to promote reforestation on private timberlands.

Selected Bibliography

Holley, D. Lester and Kirk P. Pelland. "New Tax Credit Provides Incentive for Reforestation." Forest Farmer, June 1981: 6–8, 15–16.

Society of American Foresters, Study Group on Forest Taxation. "Forest Taxation." Journal of Forestry, v. 78, July 1980: 1–7.

Streer, Paul J. and Keith A. Utz. "Timber Tax Incentives and the Small Investor." Taxes, v. 61, Jan. 1983: 59-64.

U.S. Congress. Conference Report to Accompany H.R. 4310. *Recreational Boating Safety Act and Facilities Improvement Act of 1980.* 96th Cong., 2d sess., Sept. 16, 1980: 16–19.

U.S. Department of Agriculture, Forest Service. *The Timber Owner and His Federal Income Tax.* Agriculture Handbook No. 274, Revised July 1975. Washington, D.C.: U.S. Government Printing Office.

CAPITAL GAINS TREATMENT OF IRON ORE

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	(1)	(1)	(1)
1987	(1)	(1)	(1)
1988	(1)	(1)	(1)
1989	(1)	(1)	(1)
1990	(1)	(1)	(1)
1991	(1)	(1)	(1)

[1] Less than $50 million.

Authorization

Sections 631(c) and 1231(b).

Description

Owners of economic interests in domestic iron ore deposits which have been held more than 1 year prior to disposition, including lessors but not including any person who is a principal in the mining of iron, who disposes of the iron ore by any form of contract in which he retains an economic interest in the iron ore disposed of, must treat the difference between the depletion basis and amount realized, including royalties, as capital gains rather than as ordinary income. Percentage depletion is not available in such cases.

This provision cannot be used by taxpayers obtaining iron ore royalties from related individuals or corporations.

Impact

The extent to which this provision results in tax saving depends on how the benefits compare with those from percentage depletion. In past years, percentage depletion on coal often has been large enough relative to profits to subject many firms to the "net income limitation" which limits percentage depletion to 50 percent of net income. In contrast, this apparently has not been the case for iron ore where the percentage depletion deduction is less likely to be subject to the net income limitation.

For corporations, a percentage depletion deduction equal to 50 percent of net income reduces the marginal tax rate to 23 percent (one-half of 46 percent), whereas capital gains treatment results in a 28-percent tax rate. However, if the mine has a high basis for calculating cost depletion (which can be claimed ratably as an offset to capital gains), the election of this provision may result in a lower tax. Similarly, if the percentage depletion deduction is less than the net income limitation, capital gains treatment may be preferred.

For individuals, the tax reduction from the capital gains deduction (60 percent) will exceed the maximum deduction available for the percentage depletion when the net income limitation is applicable. In general, therefore, capital gains treatment will be more favorable to individuals than percentage depletion.

The tax expenditure associated with this provision is the incremental reduction in overall tax liability available to taxpayers able to avail themselves to capital gains treatment and cost depletion over what their tax liability would have been had they been restricted to ordinary income treatment and percentage depletion.

Rationale

Capital gains treatment for coal royalties was adopted in the Revenue Act of 1951. The legislative history suggests it was adopted to: (1) extend the same treatment to coal lessors as that allowed to timber lessors; (2) provide benefits to long-term lessors with low royalty rates who were unlikely to benefit significantly from the percentage depletion deduction; and (3) encourage the leasing and production of coal.

Capital gains treatment of iron ore royalties was added in the Revenue Act of 1964 to make the treatment of iron ore generally consistent with coal, and to encourage leasing and production of iron ore deposits in response to foreign competition.

Selected Bibliography

Agria, Susan. "Special Tax Treatment of Mineral Industries," in: Arnold C. Harberger and Martin H. Bailey, eds. *The Taxation of Income from Capital.* Washington, D.C.: The Brookings Institution, 1969: 77-122.

U.S. Congress. House. Committe on Ways and Means. *General Tax Reform.* Hearings. Testimony of E. V. Leisenring, National Coal Association. 93rd Cong., 1st sess., Mar. 19-20, 1973: 2223-2230.

(300) Natural Resources and Environment

EXCLUSION OF INTEREST ON STATE AND LOCAL GOVERNMENT POLLUTION CONTROL AND SEWAGE AND SOLID WASTE DISPOSAL FACILITIES BONDS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	NA	NA	NA
1987	2.8	−0.4	2.4
1988	3.2	−.5	2.7
1989	3.6	−.5	3.1
1990	4.1	−.5	3.6
1991	4.7	−.6	4.1

Authorization

Section 103(b)(4)(E) and (F) of the Internal Revenue Code of 1954.

Description

Interest on industrial development bonds (IDB's) used to finance the construction or purchase of air and water pollution control facilities or public sewage or solid waste disposal facilities is excludable from gross income. (For a description of industrial development bonds generally, see the section in function 370 on the Exclusion of Interest on State and Local Industrial Development Bonds.)

As in the case of other industrial development bonds, a State or local government issues pollution control or sewage or solid waste disposal bonds that are backed by the rents received from facilities built with the bond proceeds. The proceeds are typically used to construct or purchase equipment that is leased to a private firm. The firm then guarantees payment of the bonds. Interest on the bonds is tax exempt because in form, if not in substance, the bonds are the debt of a State or local government.

Impact

Tax-exempt pollution control bonds subsidize the cost of complying with antipollution regulations; similarly, sewage or solid waste disposal bonds subsidize the cost of constructing those facilities. Because the interest is tax exempt, the issuer can attract bond purchasers with lower interest rates than the lessee of the equipment would pay if it issued taxable bonds. In this manner, the exclusion from gross income of the interest reduces the interest costs of pollution control or waste disposal equipment.

Principal users of pollution control bonds are electric utilities, metal producers and processors, oil companies, chemical companies, and paper companies. Most pollution control bond issues are made to finance pollution control equipment for large private firms.

Bonds for sewage and solid waste facilities are limited to facilities available for use by the general public (i.e., not limited to any one specific business or businesses).

Reported pollution control bond sales rose from an estimated $93 million in 1971 to $4.5 billion in 1983. This represented 4.8 percent of total long-term municipal debt. Reported sewage and solid waste disposal bond sales were $1.4 billion in 1983 (1.5 percent of the total).

The growth in the use of pollution control and other industrial development bonds has exerted strong pressure on all tax-exempt interest rates, reduced the attractiveness of tax-exempt issues generally relative to taxable issues, and diluted the effectiveness of the exclusion. Critics have pointed out that, as with the exclusion of interest on all State and local debt, some of this foregone revenue flows into investors' pockets without reducing actual borrowing costs.

The purchasers of pollution control and sewage and solid waste disposal bonds are both institutional and individual investors. The market for the bonds is much the same as that for other IDB's.

Under the Deficit Reduction Act of 1984, IDB's for pollution control and for sewage and solid waste disposal facilities are subject to the overall volume limitation for private activity tax-exempt bonds. The amount of all such bonds which may be issued in a State during any given year is equal to the greater of (1) $150 for each resident of the State, or (2) $200 million.

Rationale

The Congress lifted the constraints on tax-exempt pollution control bonds in the Tax Reform Act of 1969 in anticipation of the passage of antipollution regulatory legislation. Since the projected costs of compliance were considered high, the Congress created a vehicle through which the Federal Government would share these costs with the private sector.

The exemption for interest on bonds for sewage and solid waste facilities was based on the arguable public character of such facilities. This exemption was expanded in 1980 to include certain processes which utilize fuels derived from processed solid wastes.

Further Comment

As with other tax-exempt municipal debt, the proliferation of pollution control and sewage and solid waste disposal bonds has elicited suggestions for alternative subsidies. These include subsidized taxable bonds and alternative tax incentives, such as special investment tax credits and immediate deduction of the cost of equipment. The volume cap and other IDB limitations included in the 1984 Act reduced, but did not eliminate, the subsidy provided by IDB's in general. (For a more detailed discussion, see the section in function 370 on the Exclusion of Interest on State and Local Industrial Development Bonds.)

Selected Bibliography

Forbes, Ronald W. and John E. Petersen. "Background Paper," in: *Building a Broader Market: Report of the Twentieth Century Fund Task Force on the Municipal Bond Market.* New York: McGraw-Hill, 1976: 43-54, 77-88.

Fortune, Peter. *The Financial Impact of the Federal Water Pollution Control Act: The Case for Municipal Bond Reform.* Cambridge, Mass.: Harvard Institute of Economic Research, 1975.

Lane, Leonard Lee. "Do Pollution Control Bonds Control Pollution?" Tax Notes, Mar. 29, 1976: 22-23.

Lee, Dwight R. "Monitoring and Budget Maximization in the Control of Pollution." Economic Inquiry, v. 21, Oct. 1983: 565-575.

Petersen, John. "The Pollution Control Bond: A Costly Subsidy." Tax Notes, v. 4, Mar. 29, 1976: 16-21.

Peterson, George and Harvey Galper. "Tax-Exempt Financing of Private Industry's Pollution Control Investment." Public Policy, winter 1975: 81-103.

U.S. Congress. Congressional Budget Office. *Reducing the Federal Deficit: Strategies and Options.* February 1982: 194-197.

U.S. Department of the Treasury. *The President's 1978 Tax Program: Detailed Description and Supporting Analyses of the Proposals.* Jan. 30, 1978: 241-245.

(300) Natural Resources and Environment

EXCLUSION OF PAYMENTS IN AID OF CONSTRUCTION OF WATER, SEWAGE, GAS, AND ELECTRIC UTILITIES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986		0.1	0.1
1987		.1	.1
1988		.1	.1
1989		.1	.1
1990		.1	.1

Authorization

Sections 118(b) and 362(c).

Description

"Contributions in aid of construction" to water and sewage disposal utilities are not included in the utilities' gross income if the contributions are spent for the construction of certain facilities within 2 years after receipt of the contributions. This treatment is extended only to regulated utilities that provide steam, electric energy, gas (through a local distribution system or transportation by pipeline), water or sewage disposal services to the general public in their service areas. In general, a qualifying contribution in aid of construction is made by a builder-developer, either as funds paid to a qualifying utility which uses them to build public utility facilities, or else as completed facilities transferred to the utility. Customer connection fees do not qualify as nontaxable capital contributions. These connection fees include payments made by customers for the cost of installing connections between their property and a utility's main distribution or disposal line.

Qualifying contributions may not be included in the rate base for ratemaking purposes by the regulatory body having ratemaking jurisdiction. No depreciation may be claimed and no investment credit may be taken with respect to any property acquired as the result of a qualified expenditure.

Impact

If contributions in aid of construction were taxable currently, utilities would: (1) pay tax on the contributions; (2) claim the investment credit on facilities constructed with the qualifying contributions; and (3) depreciate the facilities over their appropriate useful lives. Thus, if contributions were currently taxable, over time, utilities would recover the resulting tax payments through depreciation deductions. In effect, compared to the treatment of contributions in aid of construction as taxable income, the treatment as nontaxable contributions under sections 118(b) and 362(c) constitutes a tax deferral rather than an exclusion.

Since amounts collected as contributions to capital are not included in a utility's rate base, they cannot result in increased rates to consumers or increased utility gross income. Absent the exclusion, the costs of water or sewage disposal contributions in aid of contruction probably would be passed on by a utility to the developers and builders who receive services directly related to these contributions. In turn, the developers and builders would pass on part or all of the costs to their customers.

Rationale

Prior to 1958, all public utilities had been permitted to exclude from gross income currently the contributions they had received in aid of construction of facilities. In 1958, under Rev. Rul. 58-555, the IRS limited this favorable treatment to regulated utilities.

However, in 1975, in Rev. Rul. 75-557, the IRS held that amounts paid by a home purchaser as a connection fee to obtain water service were includable currently in a utility's income.

For many regulated utilities, the issuance of Rev. Rul. 75-557 had no tax effect as far as connection fees were concerned because these fees had historically been included in gross income. The problem, however, was that Rev. Rul. 75-557 might have been construed by the IRS as applying to more than just connection fees, and might have subjected to tax for the first time contributions in aid of construction, which previously had been excluded as nonshareholder contributions to capital. It was unclear under the relevant case law whether various types of contributions in aid of construction constituted taxable income. The present statute was originally enacted in 1976 to clarify the exclusion for regulated water and sewage utilities, subject to the limitations described above. In 1978, these provisions were extended to contributions made to regulated public gas, electric, and steam utilities.

Selected Bibliography

U.S. Congress. Joint Committee on Taxation. *General Explanation of the Revenue Act of 1978,* Mar. 12, 1979: 214-216.

TAX INCENTIVES FOR PRESERVATION OF HISTORIC STRUCTURES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	1.2	0.1	1.3
1987	1.4	.1	1.5
1988	1.5	.2	1.7
1989	1.6	.2	1.8
1990	1.7	.2	1.9
1991	1.8	.2	2.0

Authorization

Section 48(g).

Description

Owners of historic buildings are encouraged to renovate them by a 25-percent tax credit available for amounts spent on substantial rehabilitations approved by the Department of the Interior. Owners are restricted to a straight-line recovery method for these expenditures, but can recover them over an 18-year period. Part of the credit is recaptured if the property is sold within the first 5 years. The credit, enacted in 1981, applies to expenditures made after January 1, 1982, and replaces provisions enacted in 1976 that allowed owners of historic structures either to amortize rehabilitation expenditures over a 5-year period or to use a depreciation method normally allowed only for new structures.

Impact

The Interior Department's National Park Service approved 1,400 out of 3,400 applications that were received in 1984; estimated average rehabilitation expenditures for an approved project was $595,000. The National Park Service estimates that it will receive about 3,800 applications with total estimated rehabilitation expenditures of $2.4 billion. From 1977, when tax incentives for historic preservation first became available, until 1981, about 3,500 project applications were received by the Interior Department, with total rehabilitation expenditures estimated at $1.6 billion. There has been a substantial increase in applications since 1981 when the tax incentive was put in the form of a 25-percent investment tax credit.

Rationale

The tax provisions (60-month, straight-line, amortization) adopted in 1976 were meant to further the goal of rehabilitating and preserving historic structures and neighborhoods. Achievement of this goal was thought initially to be dependent upon the enlistment of private funds in the preservation movement. The Congress believed tax considerations play an important role in determining whether private interests will maintain and rehabilitate historic structures, consequently, the tax incentives were changed to a tax credit in 1981 and made part of a three-tier investment tax credit for rehabilitating older buildings.

Selected Bibiography

Bennett, Mary. "Encouraging Historic Preservation Through the Federal Tax System: The Tax Reform Act of 1976." Columbia Journal of Environmental Law, spring 1978: 221–253.

Feigenbaum, Susan and Thomas Jenkinson. "Government Incentives for Historic Preservation." National Tax Journal, v. 37, Mar. 1984: 113–119.

Flesher, Dale L. "Historic Structures as Tax Shelters (and Traps)." Taxes, v. 57, July 1979: 411–415.

Gensheimer, Cynthia F. "Rehabilitation Tax Credits Enacted in the Economic Recovery Tax Act of 1981." Journal of Real Estate Taxation, v. 9, summer 1982: 299–319.

Kenost, Robert M. "Tax Incentives for Qualified Rehabilitated Buildings and for Donations of Preservation Easements." 41st Annual Institute on Federal Taxation. New York University. 1983: 20–1–0–37.

Limberg, Stephen T. "An Analysis of the Incentives Provided by the Rehabilitation Tax Credit." Journal of Taxation, v. 59, Dec. 1983: 380–386.

National Trust for Historic Preservation. *Tax Incentives for Historic Preservation.* Washington, D.C., 1980.

———. "Tax Incentives; New Investment Opportunities in Economic Recovery Tax Act of 1981." Preservation News Supplement, Nov. 1981.

Roddewig, Richard J. and Michael S. Young. "Neighborhood Revitalization and the Historic Preservation Incentives of the Tax Reform Act of 1976: Lessons From the Bottom Line of a Chicago Red Brick Three-Flat." Urban Lawyer, winter 1979: 35–74.

Small, Stephen J. "The Tax Benefits of Donating Easements in Science and Historic Property." Real Estate Law Journal, v. 7, spring 1979: 304–319.

U.S. Congress. Joint Committee on Taxation. *General Explanation of the Revenue Act of 1978,* Mar. 12, 1979: 155–58.

———. *General Explanation of the Tax Reform Act of 1976,* Dec. 29, 1976: 643–645.

———. *General Explanation of the Economic Recovery Tax Act of 1981,* Dec. 29, 1981: 111–116.

U.S. Department of the Interior, Heritage Conservation and Recreation Service. *Federal Tax Provisions to Encourage Rehabilitation of Historic Buildings: An Assessment of Their Effect.* 1979.

U.S. General Accounting Office. *Report to the Joint Committee on Taxation: Information on Historic Preservation Tax Incentives.* Report No. GAO-GGD: 84-47, March 29, 1984.

Weinner, Douglas. *Summary and Legal Analysis of Historic Preservation Tax Incentives Under the Internal Revenue Code.* Multilith No. 85-813. The Library of Congress, Congressional Research Service. Washington, D.C., June 12, 1985.

PREMATURE ACCRUAL OF MINE RECLAMATION AND SIMILAR EXPENSES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	(1)	(1)	(1)
1987	(1)	(1)	(1)
1988	(1)	.1	.1
1989	(1)	.1	.1
1990	(1)	.1	.1
1991	(1)	.1	.1

[1] Less than $50 million.

Authorization

Section 468.

Description

Under the Tax Reform Act of 1984 (TRA), an accrual basis taxpayer generally is not allowed to deduct a future liability until economic performance occurs (section 461(h)). However. the TRA provided electing taxpayers with a uniform method for deducting, prior to economic performance, certain reclamation costs which are mandated by Federal or State law.

Taxpayers who elect the special accrual rules may deduct the estimated current cost of reclaiming mine and waste disposal sites in the future, provided reclamation is conducted in accordance with a plan or permit pursuant to certain Federal and State statutes. (Similar rules apply to site closing costs.) For Federal income tax purposes, amounts deducted prior to economic performance are deemed deposited in a site-specific sinking fund. The sinking fund is deemed to earn interest according to the following schedule: 70 percent of the short-term rate in Code section 1274 (compounded semiannually) in tax years ending in 1984 and 1985, 85 percent in 1986, and 100 percent in tax years ending on or after January 1, 1987. The excess, if any, of the sinking fund balance over the amounts actually expended for site reclamation or closing costs is taxed as ordinary income (i.e., recaptured) when site reclamation is substantially completed.

Impact

Section 468 permits a deferral of tax liability by allowing a deduction for reclamation and similar costs prior to economic performance. However, an interest charge is effectively imposed on this deferral of tax liability since premature deductions are recaptured with interest. Thus, relative to the general rule of accruing future liabilities when economic performance occurs, the premature accrual of reclamation and similar costs reduces tax revenues in early years but, in theory, raises revenues by a larger amount in some future year.

Rationale

Proponents argue that premature accrual of mine reclamation and similar expenses is necessary to encourage mine reclamation and similar activities, and to prevent the adverse economic effect on mining companies that might result from applying the general rules in section 461(h).

Selected Bibliography

U.S. Congress. Joint Committee on Taxation. *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984.* Committee Print. 98th Cong., 2d sess., Dec. 31, 1984: 273–276.

EXPENSING OF CERTAIN CAPITAL OUTLAYS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	(1)	0.1	0.1
1987	0.1	(1)	.1
1988	.1	(1)	.1
1989	.1	.1	.2
1990	.2	.1	.3
1991	.2	.1	.3

[1] Less than $50 million.

Authorization

Sections 162, 175, 180, 182, 278, 447, 461, 464, 465, and 704(d) of the Internal Revenue Code of 1954.

Description

Subject to specified restrictions regarding prepayment of costs, most farm businesses may use the cash method of tax accounting to deduct costs attributable to goods held for sale and in inventory at the end of the tax year. These businesses also are allowed to expense (i.e., deduct as they are incurred) some costs of developing assets that will produce income in future years. Both of these rules deviate from generally applicable tax accounting rules, which do not permit deduction of inventory costs until the inventory is sold, and which require the cost of income-producing assets to be deducted over their useful lives. These rules thus allow deductions to be claimed before the income associated with the deductions is realized.

Costs that may be deducted before income attributable to them is realized include cattle feed, expenses of planting crops for the succeeding year's harvest, and development costs such as those incurred in planting vineyards and fruit orchards. There are special rules that require outlays for developing young citrus and almond groves to be capitalized.

Certain costs that otherwise would be considered capital expenditures may be deducted immediately by all farmers pursuant to specific sections of the Internal Revenue Code. These costs include expenses for soil and water conservation (sec. 175), land clearing (sec. 182), and fertilizer (sec. 180).

Certain restrictions primarily aimed at tax shelters apply in farming deductions. Farm syndicates are restricted in their deductions of preproduction expenses, and farm loss deductions allowable to individual taxpayers are restricted to amounts "at risk," or actually invested, in a farming venture.

Impact

The effect of deducting costs before the associated incomes is realized is the understatement of income in the year of deduction followed by an overstatement when the income is realized. The net result is that tax liability is deferred from the time the deduction is taken to the asset's productive period. This affords the taxpayer an interest-free loan in the amount of the deferred tax. When the income is finally taxed, it may be taxed at preferential capital gains rates.

The expensing of capital outlays provides a general incentive for farming investments that qualify for this treatment, and particularly favors farming investments with long development periods (such as orchards and vineyards).

Rationale

The special rules with respect to development costs and cash accounting were established in regulations issued very early in the development of the tax law. At that time, because accounting methods were less sophisticated, tax rates were low, and the typical farming operation was small, the regulations apparently were adopted to simplify recordkeeping for the farmer. The statutory rules permitting deductions for soil and water conservation, land clearing expenses, and fertilizer costs were added between 1954 and 1962 to encourage conservation practices. The special requirements for capitalizing outlays for citrus and almond growers were enacted in 1969. The exclusion for certain cost-sharing payments was enacted in 1978, and special limitations on prepayments were enacted in 1984.

The Tax Reform Act of 1976 required accrual accounting for some farm corporations, and restricted deductions associated with tax shelters, in recognition, respectively, of the more sophisticated accounting methods available to some corporate farmers, and the growth of tax shelters.

The remaining use of cash basis accounting for individual and some corporate farmers is still justified by its proponents as simpler and more workable than the accrual method.

Selected Bibliography

Boxley, Robert F. and William D. Anderson. "An Evaluation of Subsidy Forms for Soil and Water Conservation," in: U.S. Congress. Joint Economic Committee. *The Economics of Federal Subsidy Programs,* Part 7—"Agricultural Subsidies," Apr. 30, 1973: 953–996.

Dunford, Richard W. "The Effects of Federal Income Tax Policy on U.S. Agriculture: A Study for The Joint Economic Committee." Washington, D.C.: GPO, 1985.

Sisson, Charles A. "An Intersectoral Examination of Tax Equity: Farm and Nonfarm Burdens." Public Finance Quarterly, v. 7, Oct. 1979: 455-478.

U.S. Congress. House. Committee on Ways and Means. *General Tax Reform. Panel Discussions.* Part 5—"Farm Operations." 93rd Cong., 1st sess., Feb. 8, 1973: 615-696.

———. *Tax Reform.* Hearings. Part 2—Farm Operations. 94th Cong., 1st sess., July 15, 1975: 1360-1402.

———. Joint Economic Committee. *The Economics of Federal Subsidy Programs.* Part 7—Agricultural Subsidies, Apr. 30, 1973: 953-976.

———. *Taxes and Agriculture.* Hearing. 98th Cong., 2nd sess., May 10, 1984.

———. Joint Committee on Taxation. *General Explanation of the Tax Reform Act of 1976,* Dec. 29, 1976: 40-42.

———. *Tax Shelters: Farm Operations.* Committee Print. 94th Cong., 1st sess., Sept. 6, 1975.

CAPITAL GAINS TREATMENT OF CERTAIN INCOME

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	0.5	NA	0.5
1987	.8	1.7	2.5
1988	.9	1.8	2.7
1989	1.0	1.9	2.9
1990	1.1	2.0	3.1
1991	1.3	2.0	3.3

Authorization

Sections 1201–1202, 1221–1223, 1231, 1245, and 1252.

Description

If gains from the sale or exchange of property used in a trade or business exceed losses from such property in any year, the gain is treated as a long-term capital gain. Long-term capital gains are taxed at lower maximum rates than ordinary income.

Real estate or depreciable property used in farming operations and held for more than a year, but not held for sale, generally qualifies as such property. However, horses and cattle qualify as property used in a trade or business only if they have been held more than 24 months.

In some cases, all or much of the cost of the farm property used in the business has previously been deducted under the farm accounting rules discussed elsewhere. Consequently, in 1969, Congress enacted legislation to tax as ordinary income some gains previously taxed as capital gain. If farmland held for less than 10 years is sold or otherwise disposed of, a percentage of the deductions allowed for soil and water conservation expenses and land clearing expenses is recaptured as ordinary income. However, the amount of the recapture cannot exceed the gain. The recapture percentages are graduated and vary from 100 percent if the land is held for 5 years or less to 0 percent after 9 years. The recapture covers only deductible soil and water conservation expenses and land clearing expenses. Thus, there is no recapture if deduction of these expenses is limited because they exceed 25 percent of gross farming income, or if the taxpayer elects to capitalize the expenses. Recapture provisions also apply to amounts accumulated prior to 1976 in the taxpayer's excess deduction account. The excess deduction account was the cumulative total of farm losses which exceeded $25,000 in any year when nonfarm income exceeded $50,000. The excess deductions account was reduced by net farm earnings and gains that were treated as ordinary income. Under the 1976 Tax Reform Act, which restricted farm loss deductions, additions to this excess deductions account for 1976 and later years were terminated.

Impact

Subject to these rules, taxpayers owning farm assets may obtain long-term capital gains treatment on qualifying assets even though much of the cost of the assets has been deducted against ordinary income. While this favorable tax treatment is limited to property used in the farming business, many farm assets have a dual potential of being held for sale or for use in the business. Assets having this ambiguous nature are often sold before the ambiguity is resolved, and the gain is treated as capital gain.

Over 90 percent of the tax saving is claimed by noncorporate farmers. The tax benefit per dollar of capital gain increases with the taxpayer's marginal rate.

In the past, the interaction between the deduction of costs and capital gains treatment for the sale of such assets resulted in many tax shelter operations in farming. However, restrictions on farm loss deductions enacted in 1976 (discussed elsewhere), have limited the attractiveness of farm tax shelters in general.

Rationale

Preferential treatment for capital gains for individuals was introduced in 1921. However, long-term capital gain treatment for property used in a trade or business was not enacted until 1942. Between 1942 and 1951, there was a dispute whether livestock qualified as such property, and legislation in 1951 gave livestock that status. The 1942 legislation was enacted to provide tax relief for war-related gains. Restrictions on loss deductions were enacted in 1976 to limit the use of farming tax shelters.

Selected Bibliography

Carlin, Thomas A. and Fred W. Woods. *Tax Loss Farming.* ERS-546, U.S. Department of Agriculture, Economic Research Service, Apr. 1974.

U.S. Congress. House. Committee on Ways and Means. *General Tax Reform.* Panel Discussions, Part 5—"Farm Operations." 93rd Cong., 1st sess., Feb. 8, 1973: 615–696.

———. *Tax Reform.* Hearings, Part 2—"Farm Operations." 94th Cong., 1st sess., July 15, 1975: 1360–1402.

———. *Tax Shelters: Farm Operations.* Committee Print. 94th Cong., 1st sess., Sept. 6, 1975.

———. Joint Economic Committee. *Taxes and Agriculture.* Hearing. 98th Cong., 2nd sess., May 10, 1984. 145.

———. Joint Committee on Taxation. *General Explanation of the Tax Reform Act of 1976,* Dec. 29, 1976: 40–62.

DEDUCTIBILITY OF PATRONAGE DIVIDENDS AND CERTAIN OTHER ITEMS OF COOPERATIVES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	−0.2	0.8	0.6
1987	−.2	.8	.6
1988	−.2	.8	.6
1989	−.2	.8	.6
1990	−.2	.9	.7
1991	−.2	.9	.7

Authorization

Sections 1381–1388.

Description

A cooperative is allowed to deduct earnings distributed to its customers (or patrons) in the form of patronage dividends or per unit retain allocations. Patronage dividends must be determined on the basis of the quantity or value of business done with the patron, and be reference to the cooperative's earnings from business with patrons. Per unit retain allocations are based upon the quantity of products marketed without reference to the cooperative's earnings.

The deduction applies to both cash dividends and noncash dividends in the form of certificates allocating amounts—retained by the cooperative—to the patrons. In order for a cooperative to deduct the noncash patronage dividends: (1) at least 20 percent of the allocation must be in cash; and (2) the allocation must be included in the patron's income, unless it is related to personal, nonbusiness expenses. Per unit retains also may be deducted by the limited types of cooperatives that can issue them, although the retains only represent allocations of earnings to patrons and are not cash dividends. A patron must treat all his patronage dividends and per unit retain allocations as taxable income.

Impact

The deduction of patronage dividends, and particularly noncash dividends, allows a cooperative effective exemption from the corporate income tax, while the cooperative still retains its earnings for reinvestment through the use of certificates of allocation. For example, if all dividends were paid in allocations, a cooperative could retain 80 percent of its earnings and incur no Federal income tax liability.

The most significant cooperatives qualifying for this treatment are agricultural cooperatives, although substantial numbers of nonagricultural cooperatives, such as consumer cooperatives, also benefit from these provisions. Cooperative credit institutions are not eligible for this special treatment, although they do benefit from other tax expenditures. Qualifying cooperatives either may be purchasing or marketing cooperatives, and may be involved in manufacturing processes as well. Exemption from the Federal income tax provides a competitive advantage for cooperatives, many of which are substantial in size, over competing incorporated businesses.

Rationale

The treatment of patronage dividends derives from rulings issued early in the 1920's which allowed patronage dividends to be deducted by cooperatives. There was no explicit rationale for such treatment, but apparently the rulings resulted from the requirement that cooperatives make these dividend payments. It was argued these payments either were costs of goods sold or price reductions, and therefore should be deductible.

In 1951, when certain formerly exempt cooperatives were made taxable, a requirement was added that patronage dividends of exempt and nonexempt cooperatives be treated in the same manner. The legislative history indicates that the intent of the Congress was to tax all earnings of cooperatives either to the patron, stockholder, or cooperative. However, when the Treasury attempted to tax allocated patronage dividends to the patrons, a series of court decisions ending with *Long Poultry Farms Inc.* v. *Commissions,* 249 F.2d 726 (4th Cir. 1957), held that allocation certificates were of contingent value and were not to be included in income. Thus, such allocations were taxable neither to the cooperative nor the patron. As a consequence, sections 1381-1388 were added in 1962 to insure that such allocations were taxable either to the patron or the cooperative.

Further Comment

Two theories are advanced for allowing the deduction of patronage dividends. The first is that such dividends actually constitute price reductions to the patrons. The second is that all earnings of the cooperative belong to its patrons, and that the cooperative is an agency of its members rather than a separate taxable enterprise.

On the other hand, current tax law treats cooperatives as taxable entities, and the deduction of patronage dividends results in effective tax exemption. Allocated patronage dividends arguably do not constitute price reductions, but rather are nonnegotiable, noninterest-bearing notes redeemable by the patrons, if ever, in the indefinite future. One might question why patrons accept such allocations in lieu of cash if the intent is a price reduction. The answer may be that the interest of the patrons is that of investors. This response is particularly relevant since cooperatives are typically owned, either through stock ownership or otherwise, by patrons.

Persons arguing that patronage dividends are not comparable to price reductions note that price reductions in a normal business have a profit motive—expanding sales and increasing profit. So-called price reductions for cooperatives in the form of patronage dividends, however, have the purpose of eliminating profit.

It is argued by some that even if the patronage dividends and per unit retains are viewed as dividends, the tax rules governing cooperatives do not result in a tax expenditure because the patrons are taxed on the dividends and the retains they receive or have attributed to them. In effect, the patrons are taxed as if they receive cash dividends and reinvest them in the cooperatives. However, the estimated revenue foregone by allowing the cooperatives full deductions for these dividends and retains far exceeds the estimated additional tax revenues paid by patrons on their patronage dividends and per unit retains.

Selected Bibliography

Caplin, Mortimer M. "Taxing the Net Margins of Cooperatives." Georgetown Law Journal, v. 58, Oct. 1969: 6–45.

Gelb, Bernard A. *Tax Exempt Business Enterprise.* New York: The Conference Board, 1971.

Schrader, Lee F. and Ray A. Goldberg. *Farmers' Cooperatives and Federal Income Taxes.* Cambridge, Mass.: Ballinger Publishing Co., 1975: 117.

U.S. Congress. House. Committee on Ways and Means. *General Tax Reform.* Hearings. 93rd Cong., 1st sess., Mar. 16, 1973: 1691–1758.

———. Joint Committee on Taxation. *General Explanation of the Revenue Act of 1978,* Mar. 12, 1979: 159–160.

———. Senate. Committee on Finance. *Net Income of Cooperatives.* Hearing. 99th Cong., 1st sess., July 15, 1985.

U.S. Department of Agriculture. *Legal Phases of Farmer Cooperatives.* Part II—"Federal Income Taxes." Information Series 100, May 1977.

Updegraft, Kenneth E. "Operating as a Nonexempt Subchapter T Cooperative." Practical Lawyer, v. 29, June 1, 1983: 29–47, 50, June 15, 1983: 33–47, 50–52.

(350) Agriculture

EXCLUSION OF CERTAIN COST-SHARING PAYMENTS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	(1)		(1)
1987	(1)		(1)
1988	(1)		(1)
1989	(1)		(1)
1990	(1)		(1)

[1] Less than $50 million.

Authorization

Section 126.

Description

There are a number of programs under which the Federal Government makes payments to taxpayers which represent a share of the cost of certain improvements made to land. Beginning with certain grant made by the Federal Government after September 30, 1979, under certain specified programs, a portion of the value of improvements financed by the grant is excluded from the recipient's gross income.

To qualify for the exclusion, the Secretary of Agriculture must determine that the payment is made primarily for the purpose of conserving soil and water resources or protecting the environment. Also, the Secretary of the Treasury must determine that the payment does not result in a substantial increase in the annual income derived from the property with respect to which the payment is made. The taxpayer is not permitted to claim the otherwise allowable deductions or credits with respect to amounts excluded under this provision.

Impact

The grants which result in exclusions from gross income do not improve the income-producing capability of the property. Also, since the grant moneys are expended by the taxpayer, he does not have additional funds to pay income tax on the grants. The income tax exclusion provides a general incentive for soil and water conservation measures that might not otherwise be undertaken.

Rationale

The partial exclusion for certain soil and water conservation payments is based on the premise that the improvements financed by these grants benefit both the general public and the individual landowner. The portion of the value of the improvement financed by grant payments attributable to public benefit is excluded from the recipient's gross income while that portion of the value primarily benefitting the landowner (private benefit) is properly taxable to the recipient of the payment.

Selected Bibliography

U.S. Congress. Joint Committee on Taxation. *General Explanation of the Revenue Act of 1978,* Mar. 12, 1979: 314–315.

———. Senate. Committee on Finance. *Technical Corrections Act of 1979.* 96th Cong., 1st sess., Dec. 13, 1979: 79–81.

———. *Net Income of Cooperatives.* Hearing. 99th Cong., 1st sess., July 15, 1985.

EXEMPTION OF CREDIT UNION INCOME

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986		0.2	0.2
1987		.4	.4
1988		.4	.4
1989		.4	.4
1990		.4	.4
1991		.5	.5

Authorization

Section 501(c)(14) of the Internal Revenue Code of 1954 and section 122 of the Federal Credit Union Act, as amended (12 U.S.C. sec. 1768).

Description

Credit unions without capital stock, and organized and operated for mutual purposes and without profit, are not subject to Federal income tax.

Impact

Because their income is exempt from the income tax, credit unions are treated more favorably than are competing financial institutions whose income is taxed. On the other hand, credit unions are subject to certain special constraints not required of their competitors, including limits on the duration of loans and on the types of investments that are allowed. In addition, credit unions may lend only to members; however, only a small deposit may be required for membership and such membership may qualify the member for a loan greatly in excess of the deposit.

Rationale

Credit unions have never been subject to the Federal income tax. Initially, they were included in the provision that exempted domestic building and loan associations—whose business was at one time confined to lending to members—and nonprofit cooperative banks operated for mutual purposes. The exemption for mutual banks and savings and loan institutions was removed in 1951, but credit unions retained their exemptions. No specific reason was given for continuing the exemption of credit unions.

Further Comment

The Carter Administration proposed in 1978 that credit unions no longer be exempt from the Federal income tax, but rather be treated in the same manner as thrift institutions. The Treasury Department indicated that the basis for this proposal was that many credit unions are no longer truly mutual institutions with limited common bonds, and are becoming virtually indistinguishable from other financial institutions.

Selected Bibliography

Croteau, John T. "Some Considerations on the Taxation of Credit Unions," in: U.S. Congress. House. Committee on Ways and Means. *Tax Revision Compendium.* Committee Print. 1959: 1833-1866.

Gelb, Bernard A. *Tax Exempt Business Enterprise.* New York: The Conference Board, 1971.

Savings and Loan News. "The Coddling of Credit Unions." July 1978: 40-43, 44-46.

U.S. Congress. Senate. Committee on Finance. *Taxation of Financial Services Industry.* Hearing. 98th Cong., 1st sess., Mar. 11, 1983.

U.S. Department of the Treasury. *The President's 1978 Tax Program: Detailed Descriptions and Supporting Analyses of the Proposals,* Jan. 30, 1978: 307-313.

EXCLUSION OF INTEREST ON LIFE INSURANCE AND ANNUITY SAVINGS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	5.4	0.3	5.7
1987	5.7	.3	6.0
1988	6.0	.3	6.3
1989	6.3	.3	6.6
1990	6.6	.3	6.9
1991	6.9	.4	7.3

Authorization

Sections 72, 101(a), and case law interpreting regulations thereunder.

Description

Most life insurance policies, other than term policies, accumulate interest-bearing reserves which benefit the policyholder by, in effect, reducing his premiums. However, this interest is not included in the policyholder's income for tax purposes as it accumulates. Pursuant to section 101(a), policy proceeds paid because of the death of the insured usually are not included in income. Therefore, when policy proceeds are not taxed at death, the previously accumulated interest is not taxed at all. If a policy is surrendered before death, only the excess of the cash surrender value over the premiums paid is included in income, with the result that the cost of the current insurance and initial expense charges can be offset against the interest income.

Income credited to an annuity contract (whether deferred or immediate) is not taxed currently to the owner of the contract or to the insurance company issuing the contract. In general, amounts received by the owner of an annuity contract before the annuity starting date (including loans under the contract) are taxed as ordinary income to the extent that the cash value of the contract exceeds the owner's investment in the contract. A portion of each distribution received after the annuity starting date is taxed as ordinary income based on the ratio of the investment in the contract to the total distributions expected to be received. Penalties are imposed on certain premature distributions under a deferred annuity contract.

Impact

The effect of the interest exclusion on life insurance savings allows personal insurance to be partly purchased with tax-free interest income. Although the interest earned is not currently paid to the policyholder, he may receive the interest payments if he terminates the policy. The definition of life insurance (sec. 7702) adopted in the Deficit Reduction Act of 1984 has placed some limitations on the amount of income that can accumulate tax-free in a contract; but even within the definitional limitations the tax-free interest income benefit can be substantial.

The effect of the tax deferral for interest credited to annuity contracts allows taxpayers to save for retirement in a tax-deferred environment without restriction on the amount that can be invested for these purposes. Although the amounts invested in an annuity are not deductible by the taxpayer as are contributions to qualified pension plans or IRA's, the tax deferral on the income credited to such investments represents significant tax benefits for the taxpayer.

These provisions thus offer preferential treatment for the purchase of life insurance coverage and for savings held in life insurance policies and for savings held in annuity contracts. Because middle-income taxpayers are the major purchasers of this insurance, they are the primary beneficiaries of the provision. Higher-income taxpayers who are not seeking insurance protection can generally obtain comparable, if not better, after-tax yields from tax-exempt State and local obligations, though insurance yields theoretically could approach those of taxable securities.

Rationale

The exclusion of death benefits paid on life insurance dates back to the 1913 tax law. While no specific reason was given for exempting such benefits, insurance proceeds may have been excluded because they were believed to be comparable to bequests, which also were excluded from the tax base.

The nontaxable status of the life insurance interest as it accumulates or the tax-deferral on annuity interest is based upon the general tax principle of constructive receipt, that is, income is taxable to a cash basis taxpayer only when it is received by, or readily available to, him. The interest income is not viewed as readily available to the policyholder because he must give up the insurance protection or any annuity guarantees by surrendering the policy in order to obtain the interest.

Further Comment

Although significant practical, social, and legal questions would be involved, the interest component could be taxed as earned or could be taxed when the life insurance proceeds are paid. Taxing the interest element when the proceeds are paid would still defer tax for the period from when it is earned until the time the proceeds are paid, but would require that the tax be paid upon death.

Selected Bibliography

Brannon, Gerard M. "A 'Peculiar Institution' in Taxation: The Tax on the Income of Life Insurance Companies." Proceedings of the Seventieth Annual Conference. Columbus: National Tax Association—Tax Institute of America, 1977: 52-57.

Burdette, Robert B. "A Simple Explanation of the New Tax Treatment of Life Insurance Companies and Their Products." Multilith No. 167. Library of Congress, Congressional Research Service, Washington, D.C.: Sept. 10, 1984.

Goode, Richard. "Policyholders' Interest Income from Life Insurance Under the Income Tax." Vanderbilt Law Review, v. 16, Dec. 1962: 33-55.

———. *The Individual Income Tax.* Rev. ed. Washington, D.C.: The Brookings Institution, 1976: 125-133.

Kotlikoff, Lawrence J. "The Impact of Annuity Insurance on Savings and Inequality." Cambridge, Mass.: National Bureau of Economic Research, 1984.

McClure, Charles E. "The Income Tax Treatment of Interest Earned on Savings in Life Insurance," in: U.S. Congress. Joint Economic Committee. *The Economics of Federal Subsidy Programs.* Part 3—"Tax Subsidies," July 15, 1972: 370-405.

U.S. Congress. Joint Committee on Taxation. *Description of Provisions of S. 1992,* relating to life insurance products and policyholders scheduled for a hearing before the Senate Committee on Finance on January 31, 1984. Committee Print. 98th Cong., 2nd sess., Jan. 27, 1984.

———. *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984,* Dec. 31, 1984: 645-663.

Senate. Committee on Finance. *Tax Treatment of Life Insurance Products and Policyholders.* Hearing. 98th Cong., 2nd sess., Jan. 31, 1984.

Vickrey, William S. *Agenda for Progressive Taxation.* New York: Ronald Press, 1947 (reprinted by Kelley, Clifton, N.J., 1970): 64-75.

———. "Insurance Under the Federal Income Tax." Yale Law Journal, v. 52, June 1943: 554-585.

(370) Commerce and Housing Credit

EXCESS BAD DEBT RESERVES OF FINANCIAL INSTITUTIONS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986		1.0	1.0
1987		.8	.8
1988		.6	.6
1989		.4	.4
1990		.6	.6
1991		.8	.8

Authorization

Sections 585, 593, and 596.

Description

In general, businesses are permitted to deduct as a current operating expense a reasonable addition to a reserve for bad debts. The allowance usually is based on the experience of prior years. However, financial institutions are permitted to compute bad debt reserves using special formulae which permit deductions in excess of actual experience.

Commercial banks compute their bad debt deductions under either the experience method or the percentage of outstanding loans method. Prior to 1969, commercial banks were permitted a bad debt deduction of 2.4 percent of outstanding loans. The 1969 Tax Reform Act reduced this figure to 1.8 percent for years through 1975, and 1.2 percent from 1976–81. The 1981 Economic Recovery Tax Act provided for bad debt deductions for commercial banks equal to 1.0 percent of outstanding loans for taxable years beginning in 1982, and 0.6 percent for years after 1982 and before 1988.

As an alternative to this treatment available for commercial banks, mutual savings banks, building and loan associations, and cooperative banks are allowed a bad debt deduction equal to 40 percent of their taxable income, if the institution's assets comprise specified proportions of certain qualified assets, which for thrifts are essentially residential mortgages. The total bad debt reserve of thrift institutions may not exceed 6 percent of qualifying real property loans, or the percentage-of-net-income bad debt deduction will be disallowed. To qualify for the full 40 percent deduction, at least 82 percent of its assets in the case of a building and loan association or cooperative bank, or 72 percent of its assets in the case of a mutual savings bank, must be invested in qualified assets. The annual bad debt deduction under this percentage-of-net-income method will be reduced if the institution's investments fail to meet the required proportion of qualified assets.

The 1981 Economic Recovery Tax Act extended the percentage-of-net-income method of computing bad debt deductions to both mutual savings banks which convert into stock associations and to newly formed stock associations so long as the institution is operated as a savings institution and is subject to the same Federal or State regulatory scheme as a mutual savings bank chartered under Federal or State law. These stock associations may compute their bad debt deduction under this method using the same rules applicable to building and loan associations (i.e., the requirement that 82 percent of their assets must be invested in qualified assets in order to receive the full 40 percent deduction and the reduction of the amount of the bad debt deduction if assets fail to meet the required amount).

Impact

Bad debt reserve deductions in excess of actual experience lower the effective tax rates of financial institutions, particularly thrift institutions, below the normal corporate tax rate of 46 percent. Apart from other means of reducing tax liability, the 40 percent bad debt allowance will result in a maximum effective tax rate for qualifying thrift institutions of 27.6 percent.[1] The 1981 Act extended the percentage-of-net-income method of computing bad debt deductions to stock associations operated as savings institutions, and, to that extent, continued the incentive for these thrift institutions to hold qualified assets, such as residential mortgages.

Rationale

The tax treatment of commercial banks evolved separately from that of thrift institutions. The allowance for special bad debt reserves of commercial banks was first provided by IRS ruling in 1947, when there was fear of a postwar economic downturn. It was intended to reflect the banking industry's experience during the depression period.

The special treatment of bad debt reserves for thrift institutions was added by statute in 1951. Prior to that time, savings and loan associations and mutual savings banks were exempt from taxation, in most instances because they were viewed as mutual organizations rather than corporations. Upon removal of this tax-exempt status, special, and very favorable, treatment of bad debt reserves was provided for savings and loan institutions and mutual savings banks, which in effect left them virtually tax exempt for a number of years thereafter. Some of the same factors which led to their tax exemption probably account for the special allowance for bad debts, especially the belief that these institutions fill an important role in providing home mortgage funds.

---

[1] $0.46-0.4(0.46)=0.276$ (without taking the minimum tax into account).

Selected Bibliography

Biederman, Kenneth R. "Savings and Loan Taxation: Old Concepts—New Directions." Proceedings of the Seventieth Annual Conference. Columbus: National Tax Association—Tax Institute of America, 1977: 44-52.

Izard, Douglas C. "Impact of Internal Revenue Code Section 585 Upon Commercial Bank Effective Tax Rates and Federal Tax Payments." Tax Executive, v. 35, 1982: 35-37, 39-43.

U.S. Congress. House. Committee on Banking, Finance and Urban Affairs. *The Report of the Interagency Task Force on Thrift Institutions.* Department of the Treasury, Chapter V—"Thrift's Tax Structure and Tax Incentives for Savings." Committee Print. 96th Cong., 2d sess., July 1980.

———. Committee on Ways and Means and Senate Committee on Finance. *Tax Reform Studies and Proposals.* U.S. Treasury Department. Chapter IX-D—"Tax Treatment of Financial Institutions." Committee Print. 91st Cong., 1st sess., Feb. 3, 1969.

———. Joint Committee on Taxation. *Taxation of Banks and Thrift Institutions.* Committee Print. 98th Cong., 1st sess., Mar. 9, 1983.

———. Senate. Committee on Finance. *Taxation of Banks and Thrift Institutions.* Hearings. 98th Cong., 1st Sess., Mar. 11, 1983.

U.S. Department of Treasury. "Report on the Financial Institution Act of 1973, A Section-by-Section Analysis." Department of the Treasury News, Oct. 11, 1973.

TAX-FREE REORGANIZATIONS OF FINANCIALLY TROUBLED THRIFT INSTITUTIONS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986		0.8	0.8
1987		.6	.6
1988		.3	.3
1989		.3	.3
1990		.3	.3
1991		.3	.3

Authorization

Sections 382, 593, and 597 of the Internal Revenue code of 1954.

Description

Under the Economic Recovery Tax Act of 1981, reorganizations of financially troubled thrift institutions may be accomplished without taxation, regardless of whether the normal continuity of interest rules applicable to tax-free reorganizations are satisfied. (These rules generally allow tax-free treatment only if shareholders of the acquired corporation receive stock in the acquiring business.) This special treatment applies only to thrift institutions (including building and loan associations, mutual savings banks, and cooperative banks) which are certified by the Federal Home Loan Bank Board (FHLBB), Federal Savings and Loan Insurance Corporation (FSLIC), or equivalent State authority as being financially troubled. In order for tax-free treatment to apply, substantially all assets and liabilities (including deposits) of the transferor must be acquired by the transferee corporation.

The 1981 Act further provided that contributions by the FSLIC to financially troubled institutions are not to be treated as taxable income. Similarly, if amounts are repaid to FSLIC, repayments of principal do not result in recapture of previous bad debt deductions.

Impact

These rules provide an effective subsidy to financially troubled thrift institutions by allowing them to reorganize on a tax-free basis and to receive FSLIC assistance free of tax, without regard to certain generally applicable tax rules.

Rationale

These rules were added in 1981 to assist thrift institutions, and the FSLIC, in a time of severely adverse conditions for the industry, resulting primarily from these institutions' holding long-term low-interest mortgages in a period of high interest rates. The rules were intended to facilitate financial assistance to thrift institutions, or reorganization into stronger institutions, with favorable tax consequences.

Selected Bibliography

Forter, Henry D. "Tax Act Helps Financially Troubled Savings and Loan Associations." Tax Advisor, v. 12, Dec. 1981: 736–738.

U.S. Congress. Joint Committee on Taxation. *General Explanation of the Economic Recovery Tax Act of 1981.* 97th Cong., 1st sess., Dec. 29, 1981.

(370) Commerce and Housing Credit

SPECIAL TAXABLE INCOME ADJUSTMENT FOR LIFE INSURANCE COMPANIES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986		0.9	0.9
1987		1.0	1.0
1988		1.0	1.0
1989		1.1	1.1
1990		1.2	1.2
1991		1.3	1.3

Authorization

Section 806(a).

Description

Under the Deficit Reduction Act of 1984, all life insurance companies are allowed a deduction equal to 20 percent of the excess of their otherwise taxable income over any small life insurance company deduction they may be entitled to.

Impact

The special life insurance company deduction has the practical effect of reducing the tax rate applied to life insurance company taxable income from the regular corporate rate of 46 percent to 36.8 percent.

Rationale

Although the Congress believed that the basic structure of the life insurance company tax provisions provided a proper reflection of the economic income of a life insurance company without a special life insurance company deduction, some adjustment was necessary to avoid suddenly imposing a substantially increased tax burden on life insurance companies. Also, the special life insurance companies deduction reduces the competitive impact of the 1984 Act, which broadened the tax base of life insurance companies without similarly broadening the tax base for competing financial institutions.

Selected Bibliography

Kopcke, Richard W. "The Federal Income Taxation of Life Insurance Companies." Federal Reserve Bank of Boston. New England Economic Review, Mar.-Apr. 1985: 5-19.

U.S. Congress. House. Committee on Ways and Means. *Tax Treatment of Life Insurance.* Hearings. 98th Cong., 1st sess., May 9, 10, 1983.

———. Joint Committee on Taxation. *Background on the Taxation of Life Insurance Companies and Their Products.* Scheduled for hearings before the Subcommittee on Select Revenue Measures of the Committee on Ways and Means on May 10-11, 1983. Committee Print. 98th Cong., 1st sess., May 5, 1983.

———. *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984.* 98th Cong., 2nd sess., Dec. 31, 1984: 580-585.

———. *Major Issues in the Taxation of Life Insurance Products, Policyholders, and Companies.* Committee Print. 98th Cong., 1st sess., Oct. 3, 1983.

(370) Commerce and Housing Credit

SMALL LIFE INSURANCE COMPANY TAXABLE INCOME ADJUSTMENT

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986		0.1	0.1
1987		.1	.1
1988		.1	.1
1989		.1	.1
1990		.1	.1
1991		.1	.1

Authorization

Section 806(b).

Description

Small life insurance companies are allowed an additional special deduction that is not available to other taxpayers. This deduction is based on otherwise taxable income and applies before the special life insurance company deduction which is generally available to all life insurance companies.

The amount of the deduction is 60 percent of so much of otherwise taxable income for a taxable year that does not exceed $3 million, reduced by 15 percent of the excess of otherwise taxable income over $3 million. Thus, the deduction phases out as a company's otherwise taxable income increases from $3 million to $15 million so that no company with otherwise taxable income over $15 million is entitled to a small life insurance company deduction.

The small life insurance company deduction is allowed only to companies with gross assets of less than $500 million. Generally, consolidated group tests are used in applying the taxable income and gross asset standards.

Impact

The small life insurance company deduction, like the special life insurance company deduction, has the practical effect of reducing the tax rate for small life insurance companies. A company eligible for the maximum small company deduction of $1.8 million combined with a further special life insurance company deduction as a practical matter is being taxed at a rate of approximately 14.8 percent instead of the regular 46 percent corporate rate.

Rationale

The small life insurance company deduction, like the special life insurance company deduction, represents a deviation from the proper measurement of the economic income of the company. However, this deduction like the other special life insurance company deduction, was adopted to prevent a dramatic increase in the tax burden of small life insurance companies as a result of the 1984 Act and to make small life insurance companies better able to compete with the giants of the industry.

Selected Bibliography

Kopcke, Richard W. "The Federal Income Taxation of Life Insurance Companies." Federal Reserve Bank of Boston. New England Economic Review, Mar.-Apr. 1985: 5-19

U.S. Congress. House. Committee on Ways and Means. *Tax Treatment of Life Insurance.* Hearings. 98th Cong., 1st sess., May 9, 10, 1983.

Joint Committee on Taxation. *Background on the Taxation of Life Insurance Companies and Their Products.* Committee Print. 98th Cong., 1st sess., May 5, 1983.

———. *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984.* 98th Cong., 2nd sess., Dec. 31, 1984: 580-584.

———. *Major Issues in the Taxation of Life Insurance Products, Policyholders, and Companies.* Committee Print. 98th Cong., 1st sess., Oct. 3, 1983.

(370) Commerce and Housing Credit

TAX EXEMPTION FOR CERTAIN INSURANCE COMPANIES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986		0.4	0.4
1987		.4	.4
1988		.5	.5
1989		.5	.5
1990		.6	.6
1991		.7	.7

Authorization

Sections 821(c) and 823(c).

Description

Under the present law, special exclusions and deductions are provided that reduce or eliminate the tax liability of certain small mutual property and casualty insurance companies. Mutual property and casualty insurance companies are exempt from Federal income tax for any taxable year if (1) they have taxable investiment and underwriting income which does not exceed $6,000 (a phase-in rule applies to income between $6,000 and $12,000) or (2) they receive not more than $150,000 from premiums and certain investment income. A special rule applies to companies whose premiums and investment income are more than $150,000, but not more than $500,000, under which only underwriting income (and not investment income) is taxable unless the company otherwise elects. In addition, a special deduction against underwriting income is provided to certain companies whose gross amount of premiums and certain investment income is less than $1,100,000.

Some organizations that sell insurance have been held to be tax-exempt under provisions of law that exempt from tax religious, charitable, or educational institutions or social welfare organizations.

Impact

The special exemptions and deductions for certain mutual property and casualty insurance companies result in different Federal income tax liability based on distinctions between underwriting and investment income. Such rules provide mutual companies that qualify under these provisions with a competitive advantage over other mutual and all stock property and casualty companies.

Rationale

The special tax provisions for qualified mutual property and casualty insurance companies were added because these companies were often not required to compute and report their underwriting income on approved forms for State insurance commission purposes. Moreover, these special provisions initially were designed to enable small, often new, companies to maintain sufficient reserves so that they could obtain reinsurance at reasonable rates.

Selected Bibliography

U.S. Congress. Joint Committee on Taxation. *Background on the Tax Treatment of Property and Casualty Insurance Companies.* Committee Print. 98th Cong., 1st sess., June 10, 1983.

———. Senate. Committee on Finance. *Taxation of Property and Casualty Insurance Companies.* Hearing. 98th Cong., 1st sess., June 13, 1983.

DEDUCTIONS OF UNPAID LOSSES OF PROPERTY AND CASUALTY INSURANCE COMPANIES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986		0.2	0.2
1987		1.7	1.7
1988		1.9	1.9
1989		2.0	2.0
1990		2.1	2.1
1991		2.3	2.3

Authorization

Section 832(b)(5).

Description

A property and casualty insurance company is permitted a deduction equal to the amount of losses incurred (including contested losses) during a taxable year on insurance contracts. The term "losses incurred" includes an estimate of the amount of incurred liabilities and of liabilities incurred but not reported by the end of the taxable year. These estimates generally are not discounted to take into consideration the present value of liabilities to be paid in future years.

Impact

The allowance of a deduction for unpaid losses of a property or casualty insurer differs from the treatment of other taxpayers in two important respects. First, insurers may estimate not only the amount of liabilities they have incurred but also the existence of the liability itself. Second, the company's ability to deduct an unpaid loss is not diminished by its decision to contest the liability. An ordinary accrual method taxpayer generally may not deduct the amount of a contested liability. The net effect of these differences generally is to permit insurers to accelerate the deduction of losses claimed relative to the timing of those deductions under the generally applicable rules.

In the cases of loss reserves or any accrual of liabilities far in advance of their expected satisfaction, the time value of the deduction may be significant. The accrual method of accounting and the reserve for unpaid losses attempt to accomplish the matching of income and deductions. However, if the time between the recognition of the income and the actual payment of the related expenses is too long, the accrual method and the unpaid loss reserve provisions could result in an understatement of a property and casualty insurance company's economic income.

Rationale

The present law deduction for undiscounted unpaid losses by property and casualty insurance companies was designed to guarantee that a company will be permitted a deduction at the time an economic loss is sustained.

Selected Bibliography

U.S. Congress. Joint Committee on Taxation. *Background on the Tax Treatment of Property and Casualty Insurance Companies.* Committee Print. 98th Cong., 1st sess., June 10, 1983.

———. Senate. Committee on Finance. *Taxation of Property and Casualty Insurance Companies.* Hearing. 98th Cong., 1st sess., June 13, 1983.

DEDUCTION FOR LIFE INSURANCE COMPANY RESERVES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986		0.6	0.6
1987		.6	.6
1988		.6	.6
1989		.7	.7
1990		.7	.7
1991		.8	.8

Authorization

Sections 805(a)(2), 807, 809(a)(2), 816(b), and 817(a).

Description

In general, life insurance companies utilize the reserve method of tax accounting. The reserves are intended to represent the company's liability to pay insurance benefits in the future. Increases in the reserves are deductible in determining the life insurance company's taxable income, while decreases are included in the gross income.

Life insurance reserves are determined according to statutorily prescribed rules which require that mortality tables, certain minimum interest rates and maximum loading charges be utilized. For purposes of determining income (which includes decreases in reserves), the amount of life insurance reserves is the greater of the amount for any contract calculated according to these statutorily prescribed rules, or the net surrender value of the contract. The Tax Reform Act of 1984 changed certain of the assumptions used in calculating life insurance reserves which resulted in a one-time reduction in the level of reserves, but the act also provided for a fresh start adjustment so that, in effect, the resulting one-time decrease in reserves is not taxed.

Impact

The reserve method permits deferral of taxation of income. In addition, because of the way in which deductible increases in reserves are calculated, inside interest buildup generally is not taxed currently, either to the life insurance company or to the policyholder. Under certain circumstances, if inside interest buildup on any given contract becomes too great in relation to the pure insurance portion of the contract, such excess is taxed to the policyholder. A portion of the interest earned in excess of the statutory rate on premiums paid escapes taxation permanently, however, if no amount is paid under the policy until the death of the insured, because the amount received under a life insurance contract by reason of the death of the insured is generally excluded from the beneficiary's income.

Rationale

The rationale for permitting life insurance companies to utilize the reserve method to account for liabilities to pay amounts under life insurance contracts is to match the time income tax is due to the time the company satisfies or is released from the obligation to pay. Inside interest buildup has not been subject to tax because such income does not ultimately belong to the insurance company, and recognition rules (such as the doctrine of constructive receipt) have not been applied to policyholders to tax such income to them.

Selected Bibliography

Kopcke, Richard W. "The Federal Income Taxation of Life Insurance Companies." Federal Reserve Bank of Boston. New England Economic Review, Mar.-Apr. 1985: 5-19.

U.S. Congress. House. Committee on Ways and Means. *Tax Treatment of Life Insurance.* Hearings. 98th Cong., 1st sess., May 1, 19, 1983.

———. Joint Committee on Taxation. *Background on the Taxation of Life Insurance Companies and Their Products.* Committee Print. 98th Cong., 1st sess., May 5, 1983.

———. *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984.* 98th Cong., 2d sess., Dec. 31, 1984: 580-584.

———. *Major Issues in the Taxation of Life Insurance Products, Policyholders, and Companies.* Committee Print. 98th Cong., 1st sess., Oct. 3, 1983.

(370) Commerce and Housing Credit

PAL ACCOUNTS FOR MUTUAL PROPERTY AND CASUALTY INSURANCE COMPANIES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986		0.1	0.1
1987		.1	.1
1988		.1	.1
1989		.1	.1
1990		.1	.1
1991		.1	.1

Authorization

Section 824 and regulations thereunder.

Description

The PAL account deduction does not represent an actual reserve established by the company on its books or a specific allocation of its assets to be held as protection against losses. Rather, the PAL account is a set of income tax adjustments which, in effect, accomplish a forward averaging of underwriting income. In general, mutual property and casualty companies are allowed to defer recognition of all or a portion of their underwriting income when they have taxable underwriting income. Some or all of this deferred portion is later recognized if the company had underwriting losses (which offset the income) or more than 5 consecutive years of underwriting gains. After an addition to the PAL account has been set aside for 5 years and has not been used to offset losses, the then unused balance is withdrawn from the PAL account and included in taxable income, except for a statutorily defined amount that remains as a cushion for future losses.

Impact

For the typical mutual company, the PAL account does not result in a permanent nonrecognition of deferred income. However, the deferral does provide a substantial economic benefit and has the practical effect of reducing the effective tax rate on mutual property and casualty companies with underwriting income. The lower effective tax rate provides a competitive advantage to mutual property and casualty companies as compared to stock property and casualty companies and life insurance companies that offer similar insurance products.

Rationale

The PAL account provisions are designed to provide mutual property and casualty companies with protection against catastrophic losses. If a stock insurance company has extraordinary losses or needs to provide for growth, it has access to the capital market. Unlike stock companies, mutuals have no stock, and thus, have no paid-in capital or shareholder surplus. Congress recognized this essential difference between stock and mutual insurers and enacted the PAL account provision to alleviate this disadvantage.

Further Comment

In the life insurance area, the same distinction between stock and mutual companies led to a different conclusion in developing the 1959 Life Insurance Company Tax Act. In the life insurance area it was concluded that stock companies needed a deferral mechanism to compete effectively with mutuals because stock companies do not have access to redundant premium charges.

Selected Bibliography

U.S. Congress. Joint Committee on Taxation. *Background on the Tax Treatment of Property and Casualty Insurance Companies.* Committee Print. 98th Cong., 1st sess., June 10, 1983.

———. Senate. Committee on Finance. *Taxation of Property and Casualty Insurance Companies.* Hearing. 98th Cong., 1st sess., June 13, 1983.

(370) Commerce and Housing Credit

EXCLUSION OF INTEREST ON STATE AND LOCAL INDUSTRIAL DEVELOPMENT BONDS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	NA	NA	NA
1987	4.2	−0.6	3.6
1988	4.4	−.5	3.9
1989	4.3	−.4	3.9
1990	4.2	−.2	4.0
1991	4.0	(1)	4.0

---

[1] Less than $50 million

Authorization

Section 103(b) of the Internal Revenue Code of 1954, as most recently amended by Title VI of Public Law 98-369 (Deficit Reduction Act of 1984).

Description

The interest on industrial development bonds (IDB's) issued by State and local governments to finance 11 categories of investment is excludable from gross income regardless of issue size. The 11 categories are: (1) residential rental family housing; (2) sports facilities; (3) convention or trade show facilities; (4) airports, docks, wharves, mass commuting facilities, and parking facilities; (5) sewage or solid waste disposal facilities or facilities for the local furnishing of electric energy or gas; (6) air or water pollution control facilities; (7) facilities for furnishing water made available to the public; (8) certain small-scale hydroelectric generating facilities; (9) qualified mass commuting facilities; (10) local district heating or cooling facilities; and (11) the acquisition or development of land for an industrial park.

The interest on IDB issues that finance other types of industrial plant and equipment investments is generally not excludable from gross income unless the issue has a face value of $1 million or less. Under certain conditions, a State or local government can elect to raise this limit to $10 million. These small issues, which are used to finance a wide variety of enterprises from manufacturing plants to professional offices, account for the largest share of all tax-exempt bonds floated for private purposes. In 1983, small issues amounted to more than $14.4 billion (up from $12.7 billion in 1982) and made up about 15.4 percent of all 1983 long-term tax-exempt bond issues.

Unlike general obligation issues, industrial development bonds are not backed by the issuing government. Rather, the bonds are guaranteed by a business. The issuer uses the proceeds of the bonds to finance the investment in plant and equipment that the business intends to utilize. Typically, the issuer leases the equipment bonds to a private firm, including in the rent the interest costs of financing the bond issue. The backing for the bonds may be the credit of the borrowing firm, the revenue from the projects financed, or the funded facility itself. If the borrower defaults, the bondholders bear the loss.

Under the Deficit Reduction Act of 1984, most IDB's and student loan bonds are subject to an overall volume limitation for private activity tax-exempt bonds. The amount of all such bonds that may be issued by a State during any given year is equal to the greater of (1) the product of $150 times the number of residents of the State, or (2) $200 million. Exemptions are provided for bonds to finance residential rental housing and publicly owned airports, docks, wharves, and mass commuting facilities; additionally, there are various transitional exemptions. The 1984 Act also denied the tax exemption for federally guaranteed bonds; restricted cost recovery for IDB-financed property; limited small issue IDB's to $40 million per business; restricted IDB use to acquire land or used facilities; eliminated the tax exemption for consumer loan bonds; and made numerous other changes in the arbitrage and other rules regarding tax-exempt bonds.

Impact

Tax-exempt IDB's subsidize private investments. Since interest on IDB's is tax exempt, potential purchasers are willing to accept lower before-tax rates of interest than on taxable securities. Consequently, the issuing government can attract bondholders with lower interest payment than corporations selling comparable bonds in the taxable market. By financing investment through IDB's, a private firm can, therefore, lower its borrowing costs.

Benefits of the tax exemption are conferred on both the holder of IDB's and the private firms using them as financing mechanisms. The allocation of benefits between the holders and the businesses depends on the spread in interest rates between the tax-exempt IDB market and the taxable bond market. The smaller the spread, the larger the proportion of benefits accruing to the IDB bondholders.

Because it is an exclusion from income, the value of this tax expenditure increases with the marginal tax rate of the bondholder. Consequently, within the household sector, IDB's tend to be held by high-income investors. In general, fire and casualty insurance companies have been attracted to IDB's because of their relatively high yields and long maturities. Commercial banks, the other major group of institutional investors in the municipals market, hold most unrated, privately placed IDB's with short maturities. In recent years, however, both banks and insurance companies have grown reluctant to increase their IDB holdings for a variety of reasons, including lower profits, the availability of alternative means of shielding income from taxation, and the relative illiquidity of unrated bonds; as a consequence, an increasing proportion of tax-exempt bonds have been held by individual investors.

Rationale

The tax-exempt status of industrial development bonds was originally established in the courts on the ground of State sovereignty. Mississippi issued the first industrial development bonds in 1936 as part of legislation to Balance Agriculture With Industry (BAWI). In 1938, the Mississippi Supreme Court upheld the constitutionality of the Mississippi Act. The U.S. Supreme Court dismissed a subsequent appeal for lack of a substantial Federal question.

Many early IDB issues were intended to promote industrial development, particularly in agricultural labor surplus areas during the Great Depression. IDB's continued to be used predominately for this purpose through the 1940's and 1950's, mostly in the Southeast. During the 1960's, the number and size of issues increased and IDB-financed facilities spread into urban areas and other regions. Between 1959 and 1968, the number of reported issues rose from 88 to 212, and the dollar value of issues rose from $32.4 million to an estimated $1.8 billion. By 1968, IDB's were in use in some 40 States.

Dollar limitations were placed on the size of tax-exempt IDB small issues in 1969 for several reasons: the growing revenue loss to the Federal Treasury; the intensification of financially debilitating competition for industry among municipalities through the extension of IDB financing; the substantial use of IDB's by large corporations that already had ample financial resources; and the pressure on interest rates throughout the municipals market generated by IDB growth. Limitations placed on IDB's as part of the Tax Reform and Fiscal Responsibility Act of 1982 (TEFRA), and the far more extensive limitations included in the Deficit Reduction Act of 1984, arose from essentially similar concerns, spurred by the dramatic growth in private activity bonds during this period.

The volume limitation contained in the 1984 Act was designed to limit private activity bonds to their 1983 level. However, the exemption of housing and public airport, etc., bonds, and the numerous transition rules included in the 1984 Act, may allow private activity bonds to reach even higher volumes before eventually leveling off. Concerns have also been expressed that the volume cap may actually increase volume in the short run, by encouraging States with relatively low issuance levels to increase their issuances to the maximum allowed by the law.

Selected Bibliography

Advisory Commission on Intergovernmental Relations. *Industrial Development Bond Financing.* A Commission Report. Washington, D.C.: June 1963.

Arkuss, Neil P. "New Federal Tax Legislation Affecting Tax-Exempt Obligations." Urban Lawyer, v. 16, fall 1984: 805–815.

Eizen, Bernard and Debra M. Csik. "Industrial Development Bonds: The Impact of the Deficit Reduction Act of 1984." Tax Advisor, v. 16, Jan. 1985: 2–6, 8–12.

Forbes, Ronald W. and John E. Petersen. "Background Paper," in: *Building a Broader Market: Report of the Twentieth Century Fund Task Force on the Municipal Bond Market.* New York: McGraw-Hill, 1976: 27–174.

Fortune, Peter. "Tax Exemption of State and Local Interest Payments: An Economic Analysis of the Issues and an Alternative." New England Economic Review, May/June, 1973: 3–31.

Institute for International Law and Economic Development. *The Industrial Revenue Bond as a Financial Attraction Device.* Sept. 1978.

Jacobs, Jerry. "Are Business Incentives Doing Their Job?" Journal of Housing, Nov./Dec. 1979: 504–512.

Rollinson, Mark. *Small Issue Industrial Development Bonds.* Chicago: Capital Publishing Corp., 1976.

U.S. Congress. Congressional Budget Office. *The Federal Role in State Industrial Development Programs,* 1984.

———. *Small Issue Industrial Revenue Bonds*, Apr. 1981.

———. *The Tax Exemption on State and Local Bonds.* Report to the House Budget Committee, Nov. 18, 1975.

———. Joint Committee on Taxation. *General Explanation of the Revenue Act of 1978*, Mar. 12, 1979: 174–175.

———. *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984.* 98th Cong., 2nd sess., Dec. 31, 1984: 920–958.

———. Senate. Committee on Small Business. Subcommittee on Urban and Rural Economic Development. *Tax-Exempt Industrial Development Bonds.* Hearing. 97th Cong., 1st sess., Oct. 5, 1981.

U.S. Department of the Treasury. *The President's 1978 Tax Program: Detailed Description and Supporting Analysis of the Proposals.* Chapter IIIB—"Tax Treatment of Industrial Development Bonds." Jan. 30, 1978: 236–248.

Zimmerman, Dennis. "Federal Tax Policy, IDBs and the Market for State and Local Bonds." National Tax Association—Tax Institute of America Symposium: Agendas for Dealing with the Deficit. National Tax Journal, v. 37, Sept. 1984: 411–420.

(370) Commerce and Housing Credit

EXCLUSION OF INTEREST ON STATE AND LOCAL HOUSING BONDS FOR OWNER-OCCUPIED HOUSING

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	NA	NA	NA
1987	2.3	0.7	3.0
1988	2.5	.8	3.3
1989	2.5	.8	3.3
1990	2.4	.7	3.1
1991	2.3	.7	3.0

Authorization

Section 103A of the Internal Revenue Code of 1954, as most recently amended by Title VI of Public Law 98-369 (Deficit Reduction Act of 1984).

Description

The interest on bonds issued by State and local governments to provide mortgages on owner-occupied houses is tax exempt for bonds issued before December 31, 1987, and until then only under certain circumstances. There are limits on the volume of bonds that can be issued in each State each year, on the purchase prices of the houses that can be financed, and on the difference between the interest rate on the bonds and the interest rate on mortgages financed with bond proceeds. In addition, with a few exceptions the purchasers of the houses must be first-time homebuyers, their incomes must be below local ceilings, and at least 20 percent of the lendable funds must be made available for mortgages in targeted areas. Bonds for veterans' housing are exempt from nearly all of these rules, including the sunset, provided that they are general obligation bonds; however, the Deficit Reduction Act of 1984 included rules designed to limit the veteran's bond program to States which issued such bonds prior to 1984, in the amounts in which such bonds were previously issued (see discussion of the veterans' housing bond program under function 700).

The issuer of mortgage bonds typically uses bond proceeds to purchase mortgages made by a private lender. The homeowners make their monthly payments to the private lender, which passes them through as payments to the bondholders.

Under the Deficit Reduction Act of 1984, mortgage bond issuers may trade in bond authority for authority to issue equivalent (or slightly greater) amounts of mortgage credit certificates (MCCs). MCCs take the form of nonrefundable tax credits for interest paid on qualifying home mortgages.

Impact

Tax-exempt housing bonds subsidize private housing. Since interest on the bonds is tax exempt, investors are willing to accept lower before-tax rates of interest than on taxable securities. Consequently, by financing housing through these bonds, the issuer can offer reduced mortgage interest rates.

Benefits of the tax exemption are conferred on both the bondholders and the homeowners who get their mortgages from them. The allocation of benefits between the bondholders and the homeowners depends on the spread in interest rates between the tax-exempt and taxable bond market. The smaller the spread, the larger the proportion of benefits accruing to the bondholders.

Tax-exempt bonds issued for owner-occupied housing (other than veterans' housing bonds) totaled $8.6 billion in 1982 and $11.0 billion in 1983. These bonds constituted 10.2 percent of all long-term tax-exempt bonds issued in 1982 and 11.8 percent in 1983.

The largest purchasers of these bonds tend to be individuals in high tax brackets who can most benefit from tax-exempt income.

Rationale

Tax exempt bonds for nonveterans' houses were first issued in the early 1970's by State housing agencies that already had programs for multifamily (rental) housing. In 1978, local governments began issuing bonds for owner-occupied housing. State and local governments usually direct the benefits of these programs to middle-income families. In some States most mortgages are financed by tax-exempt bonds.

The limitations imposed on nonveterans' bonds by Congress in 1980 were meant to restrict their volume and the associated Federal revenue loss and upward pressure on general tax-exempt interest rates; to direct more of the subsidy to the homebuyers, in particular first-time homebuyers purchasing moderately priced houses; and to upgrade targeted areas. Certain of these restrictions were relaxed in 1982 as a measure to stimulate a depressed housing market.

As part of the Deficit Reduction Act of 1984, Congress extended the nonveterans' mortgage bond program for 4 years, through December 31, 1987, subject to reporting and certain other requirements, and also added the MCC option. The current volume and related limitations on veterans' mortgage bonds were also imposed by that Act.

Selected Bibliography

Brockschmidt, Peggy, "Tax-Exempt Single-Family Mortgage Bonds." Economic Review. Federal Reserve Bank of Kansas City, May 1980: 3-12.

MacRae, Duncan, David Rosenbaum, and John Tuccilo. *Mortgage Revenue Bonds and Metropolitan Housing Markets.* Washington, D.C., The Urban Institute, May 1980.

Peterson, George E. and Brian Cooper. *Tax-Exempt Financing of Housing Investment.* Washington, D.C.: The Urban Institute, 1979.

U.S. Congress. Congressional Budget Office. *Tax-Exempt Bonds for Single-Family Housing,* April 1979.

———. *Experience Under the Permanent Rules of the Mortgage Subsidy Bond Tax Act of 1980,* 1982.

———. House. Committee on Ways and Means. *Omnibus Reconciliation Act of 1980.* H. Report 96-1479, 96th Cong., 2d sess., 1980: 171-184.

Verbrugge, James A. *Tax-Exempt Bonds for Single-Family Housing: An Evaluation of State Housing Finance Agency and Local Government Programs.* Chicago: United States League of Savings Associations, 1979.

EXCLUSION OF INTEREST ON STATE AND LOCAL HOUSING BONDS FOR RENTAL HOUSING

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	NA	NA	NA
1987	1.0	0.3	1.3
1988	1.1	.4	1.5
1989	1.2	.4	1.6
1990	1.2	.4	1.6
1991	1.3	.5	1.8

Authorization

Section 103(b)(4)(A) of the Internal Revenue Code and section 11(b) of the United States Housing Act of 1937, as amended.

Description

State and local governments can issue tax-exempt bonds under section 103(b)(4)(A) of the Internal Revenue Code to finance multifamily housing as long as 20 percent of the units are rented to low-income tenants (15 percent of the units in targeted areas). Most of the State agencies that have issued these bonds have done so to finance section 8 housing projects in which all tenants are low income or handicapped. For these projects, the Federal Government pays a share of the rent of each tenant, based on the tenant's income and the fair market rent determined by the Department of Housing and Urban Development. However, many local governments issue bonds to finance unsubsidized apartment buildings. Some bonds are also issued for buildings insured by the Federal Housing Administration.

Under section 11(b) of the United States Housing Act of 1937, the Department of Housing and Urban Development (HUD) can authorize the issuance by local housing agencies and their instrumentalities of tax-exempt bonds for section 8 housing projects. HUD also issues tax-exempt notes for public housing projects.

Both Code section 103(b)(4)(A) and section 11(b) housing bonds are specifically exempted from the volume limitations imposed by the Deficit Reduction Act of 1984 on public activity tax-exempt bonds.

Impact

Because interest on these bonds is tax exempt, the bonds carry lower interest rates than comparable taxable bonds. The mortgages that they finance carry low interest rates that make profitable some apartment projects that otherwise would not be built. The subsidy is split among the bondholders, the owners of the apartment buildings, and the low-income tenants.

In 1983, about $5.3 billion in tax-exempt bonds for multifamily housing was issued under section 103(b)(4)(A) of the Internal Revenue Code and section 11(b) of the Housing Act. In addition, $18.3 billion in tax-exempt federally guaranteed notes was issued in 1983 by HUD to finance public housing projects.

The imposition of a volume limit on other private activity bonds in 1984 with a specific exemption for housing bonds, may encourage further growth in this area.

Rationale

Tax exemption on the bonds is believed to stimulate the construction of new multifamily housing and to counteract other provisions of the tax code that tend to favor owner-occupied as opposed to rental housing. The provision requiring that at least 20 percent of tenants be low income was added in 1981.

Selected Bibliography

Brockschmidt, Peggy. "Tax-Exempt Single-Family Mortgage Bonds." Economic Review. Federal Reserve Bank of Kansas City, May 1980: 3-12.

MacRae, Duncan, David Rosenbaum, and John Tuccilo. *Mortgage Revenue Bonds and Metropolitan Housing Markets.* Washington, D.C.: The Urban Institute, May 1980.

Peterson, George E. and Brian Cooper. *Tax-Exempt Financing of Housing Investment.* Washington, D.C.: The Urban Institute, 1979.

U.S. Congress. Congressional Budget Office. *Tax-Exempt Bonds for Single-Family Housing,* April 1979.

———. *Experience Under the Permanent Rules of the Mortgage Subsidy Bond Tax Act of 1980,* 1982.

———. House. Committee on Ways and Means. *Omnibus Reconciliation Act of 1980.* H. Report 96-1479, 96th Cong., 2d sess., 1980: 171-184.

———. *Tax-Exempt Bonds for Multi-Family Residential Rental Property.* 99th Cong., 1st sess., June 21, 1985.

———. Joint Committee on Taxation. *Tax-Exempt Bonds for Multi-Family Residential Rental Property.* Scheduled for a hearing before the Subcommittee on Oversight of the Committee on Ways and Means on June 21, 1985. Committee Print. 99th Cong., 1st sess., June 17, 1985.

Verbrugge, James A. *Tax-Exempt Bonds for Single-Family Housing: An Evaluation of State Housing Finance Agency and Local Government Programs.* Chicago: United States League of Savings Associations, 1979.

(370) Commerce and Housing Credit

EXPENSING OF CONSTRUCTION PERIOD INTEREST AND TAXES FOR LOW-INCOME HOUSING

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	0.1	0.1	0.2
1987	.1	.1	.2
1988	.1	.1	.2
1989	.1	.1	.2
1990	.1	.1	.2
1991	.1	.1	.2

Authorization

Sections 163, 164, and 189.

Description

Interest and taxes incurred by a taxpayer during the construction of low-income housing either may be deducted (subject to limitations on the deductibility of prepayments) or may be capitalized as a part of the depreciable basis in the building. Taxpayers constructing property other than low-income housing have the option of treating these costs either as a part of the depreciable basis in the building, or as a separate capital cost to be amortized generally over 10 years.

Impact

The cost of interest and taxes paid or incurred during the construction period of low-income housing property is conceptually a cost of the constructed property. The allowance of such construction period costs as deductions when paid or incurred results in a mismatching of income and expenses by allowing the deduction of costs prior to the realization of income related to the costs. In contrast, all other construction costs are required to be capitalized and depreciated over the recovery period of the building. The effect of permitting the deduction of construction period interest and taxes is a deferral of income taxes in the nature of an interest free loan.

48-178 O - 86 - 6

Rationale

The deduction for interest and taxes was provided in the original income tax law in 1913. Although no specific rationale was stated, the legislative history suggests that such payments were viewed as reducing net income. In 1942, a provision was added to the law to allow taxpayers to elect to capitalize such costs. The Tax Reform Act of 1976 required the phased-in 10-year amortization period for construction period interest and taxes on real property for individuals, subchapter S corporations and personal holding companies. An exception was provided for low-income housing, however. The Tax Equity and Fiscal Responsibility Act of 1982 provided that all corporations would be required to capitalize construction period interest and taxes with respect to nonresidential real property. The exception for corporations constructing residential real property was repealed by the Deficit Reduction Act of 1984. The exception for low-income housing was preserved, however, in order to maintain an incentive for attracting capital for the construction of low-income housing.

Selected Bibliography

U.S. Congress. Congressional Budget Office. *Real Estate Tax Shelter Subsidies and Direct Subsidy Alternatives,* May 1977.

———. Joint Committee on Taxation. *General Explanation of the Tax Reform Act of 1976.* Dec. 29, 1976: 25–29.

———. *General Explanation of the Economic Recovery Tax Act of 1981.* Dec. 31, 1981: 176.

———. *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984.* Dec. 31, 1984: 293–294.

(370) Commerce and Housing Credit

DEDUCTIBILITY OF MORTGAGE INTEREST ON OWNER-OCCUPIED HOMES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	27.1		27.1
1987	33.0		33.0
1988	37.0		37.0
1989	44.3		41.3
1990	46.1		46.1
1991	51.5		51.5

Authorization

Section 163.

Description

A taxpayer may take an itemized deduction for mortgage interest paid on his owner-occupied home.

Impact

Homeowners are allowed to deduct their mortgage interest payments, even though the implicit rental income from their home (the income they could earn if the home were rented to someone else) is not taxed. Renters and the owners of rental property do not receive a comparable benefit. Renters may not deduct any portion of their rent, and while the owners of rental property may deduct mortgage interest, they must pay tax on the rental income they receive. The home mortgage interest deduction thus encourages home ownership by reducing its cost in comparison to renting.

Because homeownership has been such a good investment during the last decade, it has diverted investment resources from rental housing and from business capital equipment and securities. The tax advantages of homeownership have weakened the demand for rental housing, thereby encouraging a decline in new rental construction and the conversion of existing rental units to condominiums and cooperatives.

Recent developments have tended to reduce the investment value of homeownership. Fixed-rate home mortgages have not always been available, and various forms of variable-rate mortgages have been offered instead. Reduced tax rates, following enactment of the Economic Recovery Tax Act of 1981, and the availability of other attractive investment alternatives also have contributed to the changed environment for investment in homeownership. Over 20 percent of all individual income tax returns filed in 1983 used the mortgage interest deduction; the rest had no mortgage or used the minimum standard deduction because mortgage interest deductions were too small to warrant itemizing.

Rationale

The deductibility of interest from taxable income in the Federal income tax dates from 1913. No explicit rationale for this provision was advanced at the time of its enactment, but committee reports and floor debates suggest that interest payments were viewed as reductions in income that should be taken into account in determining a person's ability to pay income tax. No distinction was made between interest payments for business and nonbusiness purposes. At that time most interest was a business expense and a cost of earning income; home mortgage and consumer borrowing were far less prevalent than today.

Currently, a major justification for the deductibility of home mortgage interest payments is the desire to encourage homeownership and stimulate residential construction. Homeownership can encourage neighborhood stability, promote civil responsibility, and improve the maintenance of residential buildings.

Selected Bibliography

Aaron, Henry. "Federal Housing Subsidies," in: U.S. Congress. Joint Economic Committee. *The Economics of Federal Subsidy Programs.* Part 5—"Housing Subsidies," Oct. 9, 1972: 571-596.

———. *Who Pays the Property Tax?* Washington, D.C.: The Brookings Institution, 1975.

———. *Shelter and Subsidies: Who Benefits from Federal Housing Policies?* Washington, D.C.: The Brookings Institution, 1972.

DeLeeuw, Frank and Larry Ozanne. "The Impact of the Federal Income Tax on Investment in Housing." Survey of Current Business, v. 59, Dec. 1979: 50-61. Another version of this article appears as "Housing," in: Henry J. Aaron and Joseph A. Pechman, eds. *How Taxes Affect Economic Behavior.* Washington, D.C.: The Brookings Institution, 1977: 283-319.

Dolbeare, Cushing N. "Federal Housing Assistance: Who Needs It, Who Gets It?" National League of Cities, Washington, D.C., 1985.

Eskridge, William N., Jr. "One Hundred Years of Ineptitude: The Need for Mortgage Rules Consonant with the Economic and Psychological Dynamics of the Home Sale and Loan Transaction." Virginia Law Review, v. 70, Sept. 1984: 1083.

Giertz, J. Fred and Dennis H. Sullivan. "Housing Tenture and Horizontal Equity." National Tax Journal, v. 31, No. 4, Dec. 1978: 329-338.

Goetze, Rolf. "Federal Tax Expenditures Should Be Restructured to Aid Urban Housing." Journal of Housing, v. 37, Oct. 1980: 504-512.

Goode, Richard. *The Individual Income Tax*. Rev. ed. Washington, D.C.: The Brookings Institution, 1976: 117–125.

Hellmuth, William F. "Homeowner Preferences," in: Joseph A. Pechman, ed. *Comprehensive Income Taxation*. Washington, D.C.: The Brookings Institution, 1977.

Hendershott, Patric H. and Sheng-Cheng Hu. *Inflation and the Benefits from Owner-Occupied Housing*. NBER Working Paper No. 383, Aug. 1979.

Hoff, Reka Potgieter. "The Appropriate Role for Tax Credits in an Income Tax System." Tax Lawyer, v. 32, winter 1982: 339–368.

Laidler, David. "Income Tax Incentives for Owner-Occupied Homes," in: Arnold C. Harberger and Martin J. Bailey, eds. *The Taxation of Income from Capital*. Washington, D.C.: The Brookings Institution, 1969: 50–70.

Litzenberger, Robert H. and Howard B. Sosin. "Taxation and the Incidence of Homeownership Across Income Groups." Journal of Finance, v. 33, June 1978: 947–961.

Merz, Paul E. "Foreign Income Tax Treatment of the Imputed Rental Value of Owner-Occupied Housing: Synopsis and Commentary." National Tax Journal, v. 30, Dec. 1977: 435–439.

Meyer, Leslie K. and John R. Meyer. "The Impact of National Tax Policies on Homeownership." Working Paper No. 71, Cambridge, Mass.: Joint Center for Urban Studies of MIT and Harvard University, 1981.

Poterba, James M. "Inflation, Income Taxes, and Owner-Occupied Housing." NBER Working Paper No. 553, Sept. 1980.

Rosen, Harvey S. "Housing Decisions and the U.S. Income Tax: An Economic Analysis." Journal of Public Economics, v. 11, No. 1, Feb. 1979: 1–23.

Sunley, Emil M., Jr. "Tax Advantages of Homeownership Versus Renting: A Cause of Suburban Migration?" Proceedings of the Sixty-Third Annual Conference on Taxation, 1970. Columbus, Ohio: National Tax Association, 1971: 337–392.

Surrey, Stanley R. *Pathways to Tax Reform*. Chapter VII—"Three Special Tax Expenditure Items: Support to State and Local Governments, to Philanthropy, and to Housing." Cambridge, Mass.: Harvard University, 1973.

U.S. Congress. Congressional Budget Office. *Federal Housing Policy: Current Programs and Recurrent Issues*. Washington, D.C., 1978.

———. *The Tax Treatment of Homeownership: Issues and Options*. Washington, D.C., 1981.

———. House. Committee on Banking, Finance and Urban Affairs. Subcommittee on the City. *Federal Tax Policy and Urban Development*. Hearing. 95th Cong., 1st sess., June 16, 1977. See especially: G. Tolley and D. Diamond, "Homeownership, Rental Housing, and Tax Incentives," 114–195.

———. House. Committee on the Budget. Task Force on Tax Expenditures and Off-Budget Agencies. *Mortgage Interest Tax Credit*. Hearing. 94th Cong., 2d sess., Feb. 25, 1976.

White, Michelle J. and Lawrence J. White. "The Tax Subsidy to Owner-Occupied Housing: Who Benefits?" Journal of Public Economics, v. 7, No. 1, Feb. 1977: 111a–126.

(370) Commerce and Housing Credit

DEDUCTIBILITY OF PROPERTY TAX ON OWNER-OCCUPIED HOMES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	NA		NA
1987	9.6		9.6
1988	10.9		10.9
1989	12.4		12.4
1990	14.1		14.1
1991	16.0		16.0

Authorization

Section 164.

Description

Taxpayers may claim an itemized deduction for property taxes paid on owner-occupied homes.

Impact

Like the deduction for home mortgage interest, the Federal deduction for real property taxes serves to reduce the overall cost of homeownership, and to increase the investment value of homeownership. (See the section in function 370 on the Deductibility of Mortgage Interest on Owner-Occupied Homes for more detail on these effects.) The deductibility of real property taxes has the additional effect of making it possible for States and localities to impose and collect somewhat higher property taxes than they otherwise could, since the deductibility of the tax lessens its burden somewhat and may reduce homeowner resistance to higher property taxes. It thus has effects similar to a general revenue sharing program. Like all personal deductions, the property tax deduction provides uneven tax savings per dollar of deduction; the tax savings are higher for those with higher marginal tax rates, and those homeowners who do not itemize their deductions receive no direct tax savings at all.

Rationale

The deductibility of real property taxes dates from the beginning of the Federal income tax. A major rationale for the deduction was that non-Federal tax payments reduce disposable income and thus should be deducted when determining a taxpayer's ability to pay the Federal income tax. The deduction has also been viewed as an important way of promoting fiscal federalism. By allowing property taxes to be deducted in the same way as all other State and local taxes, the Federal Government avoids interfering in State and local decisions on the type of tax to rely on. In addition, the deductibility of property taxes against the Federal income tax helps to equalize overall effective tax burdens among States and localities; citizens in high-tax jurisdictions pay somewhat lower Federal taxes as a result of their higher deductions, and vice versa.

Selected Bibliography

Aaron, Henry. "Federal Housing Subsidies," in: U.S. Congress. Joint Economic Committee. *The Economics of Federal Subsidy Programs.* Part 5—"Housing Subsidies," Oct. 9, 1972: 571-596.

———. *Who Pays the Property Tax?* Washington, D.C.: The Brookings Institution, 1975.

———. *Shelter and Subsidies: Who Benefits from Federal Housing Policies?* Washington, D.C.: The Brookings Institution, 1972.

DeLeeuw, Frank, and Larry Ozanne. "The Impact of the Federal Income Tax on Investment in Housing," Survey of Current Business, v. 59, Dec. 1979: 50-61. Another version of this article appears as "Housing," in: Henry J. Aaron and Joseph A. Pechman, eds. *How Taxes Affect Economic Behavior.* Washington, D.C.: The Brookings Institution, 1977: 283-319.

Giertz, Fred, Jr. and Dennis H. Sullivan. "Housing Tenure and Horizontal Equity." National Tax Journal, v. 31, No. 4, Dec. 1978: 329-338.

Goetze, Rolf. "Federal Tax Expenditures Should Be Restructured to Aid Urban Housing." Journal of Housing, v. 37, Oct. 1980: 504-512.

Goode, Richard. *The Individual Income Tax.* Rev. ed. Washington, D.C.: The Brookings Institution, 1976: 117-125.

Hellmuth, William F. "Homeowner Preferences," in: Joseph A. Pechman, ed. *Comprehensive Income Taxation.* Washington, D.C.: The Brookings Institution, 1977.

Hendershott, Patric H., and Sheng-Cheng Hu. "Inflation and the Benefits From Owner-Occupied Housing." NBER Working Paper No. 383, Aug. 1979.

Laidler, David, "Income Tax Incentives for Owner-Occuppied Homes," in: Arnold C. Harberger and Martin J. Bailey, eds. *The Taxation of Income from Capital.* Washington, D.C.: The Brookings Institution, 1969: 50-70.

Litzenberger, Robert H. and Howard B. Sosin. "Taxation and the Incidence of Homeownership Across Income Groups." Journal of Finance, v. 33, June 1978: 947-961.

Merz, Paul E. "Foreign Income Tax Treatment of the Imputed Rental Value of Owner-Occupied Housing: Synopsis and Commentary." National Tax Journal, v. 30, Dec. 1977: 435-439.

Meyer, Leslie K., and John R. Meyer. "The Impact of National Tax Policies on Homeownership." Working Paper No. 71. Cambridge, Mass.: Joint Center for Urban Studies of MIT and Harvard University, 1981.

Poterba, James M. "Inflation, Income Taxes, and Owner-Occupied Housing." NBER Working Paper No. 553, Sept. 1980.

Rosen, Harvey S. "Housing Decisions and the U.S. Income Tax: An Economic Analysis." Journal of Public Economics, v. 11, No. 1, Feb. 1979: 1-23.

Sunley, Emil M., Jr. "Tax Advantages of Homeownership Versus Renting: A Cause of Suburban Migration?" Proceedings of the Sixty-Third Annual Conference on Taxation, 1970. Columbus, Ohio: National Tax Association, 1971: 377-392.

Surrey, Stanley R. *Pathways to Tax Reform.* Chapter VII—"Three Special Tax Expenditure Items: Support to State and Local Governments, to Philanthropy, and to Housing." Cambridge, Mass.: Harvard University, 1973.

U.S. Congress. Congressional Budget Office. *Federal Housing Policy: Current Programs and Recurrent Issues.* Washington, D.C., 1978.

———. *The Tax Treatment of Homeownership: Issues and Options.* Washington, D.C., 1981.

———. House. Committee on Banking, Finance and Urban Affairs. Subcommittee on the City. *Federal Tax Policy and Urban Development.* Hearing. 95th Cong., 1st sess., June 16, 1977. See especially: G. Tolley and D. Diamond. "Homeownership, Rental Housing, and Tax Incentives," 114-195.

———. Committee on the Budget. Task Force on Tax Expenditures and Off-Budget Agencies. *Mortgage Interest Tax Credit.* Hearing. 94th Cong., 2d sess., Feb. 25, 1976.

White, Michelle J. and Lawrence J. White. "The Tax Subsidy to Owner-Occupied Housing: Who Benefits?" Journal of Public Economics, v. 7, No. 1, Feb. 1977: 111-126.

(370) Commerce and Housing Credit

DEFERRAL OF CAPITAL GAINS ON HOME SALES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	5.9		5.9
1987	6.4		6.4
1988	6.9		6.9
1989	7.5		7.5
1990	8.0		8.0
1991	8.6		8.6

Authorization

Section 1034.

Description

Capital gains from the sale of a principal residence are excluded from taxable income when another residence costing at least as much is purchased within 2 years of the sale of the former one. In figuring the sale price, taxpayers may deduct the cost of any expense incurred "to assist in its sale." If the new residence costs less than the old, adjusted as indicated above, only the amount by which it falls short of the selling price of the old unit is taxed as a capital gain. The deferral is limited to one such sale during any one 2-year period, except for taxpayers whose move is "in connection with the commencement of work . . . at a new principal place of work."

Impact

Deferring the capital gains tax on home sales avoids putting an additional burden on owners who have to sell because of an increase in family size or an employment change. At the same time, this special tax treatment gives homeownership a competitive advantage over other types of investment, since 40 percent of the capital gain from investments in other assets is taxed when the asset is sold. As a result, savings are diverted out of other forms of investment and into housing.

Rationale

The deferral of capital gains from home sales was first introduced in 1951. Committee reports and floor debates at the time indicate that the Congress believed that taxing these capital gains imposed a "hardship," because capital gains may reflect only a general rise in housing prices—in which case the tax on the gain for homeowners who moved would reduce their ability to replace the home they had sold. The inequity was considered particularly great when such events as an increase in family size or a change in employment required the move. In that case, the sale of a house was said to have the character of an "involuntary conversion." Although the taxation of gains from other assets also made it impossible to acquire property having the same price as the assets sold without other sources of financing, the Congress singled out home sales for special treatment because they were considered to result mostly from personal reasons or uncontrollable circumstances, rather than the desire to make a profit.

Selected Bibliography

Greenberger, Robert M. "Tax Shelter Possibilities Available When a Principal Residence Is Disposed of by a Client." Taxation for Accountants, v. 24, Mar. 1980: 158–163.

Hill, D. Frank III. "The Personal Residence: Disposition Alternatives." 86 West Virginia Law Review, v. 86, summer 1984: 1275–1302.

U.S. Congress. Congressional Budget Office. *The Tax Treatment of Homeownership: Issues and Options,* 1981.

———. House. Committee on Ways and Means. *General Tax Reform.* Panel Discussions, Part 2—"Capital Gains and Losses." 93d Cong., 1st sess., Feb. 7, 1973 (note particularly the statement of Kenneth B. Sanden, 254).

———. Joint Committee on Taxation. *General Explanation of the Economic Recovery Tax Act of 1981.* Dec. 31, 1981: 51–52.

Wensman, Michael J. "Sale of a Residence: Gain Rollover Issues Raised by Split Equity Financing." Journal of Real Estate Taxation, v. 11, winter 1984: 159–178.

EXCLUSION OF CAPITAL GAINS ON HOME SALES FOR PERSONS AGE 55 AND OVER

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	2.0		2.0
1987	2.1		2.1
1988	2.3		2.3
1989	2.5		2.5
1990	2.7		2.7
1991	2.9		2.9

Authorization

Section 121.

Description

Taxpayers age 55 and older are allowed a one-time exclusion from taxable income of $125,000 in capital gains on the sale of any property used as a principal residence during 3 of the previous 5 years.

Impact

This provision, together with the deferral of gains on previous home sales, allows older taxpayers to avoid some or all of the tax liability that would otherwise accrue from price increases in the value of their homes. Without this exclusion, many taxpayers who become renters would be required to pay tax on approximately the difference between the sale price of their final home and the purchase price of their first (less the accumulated costs of real estate commissions transfer taxes, and the like). Since home prices have appreciated significantly in the last decade, the resulting tax liabilities could reduce the after-tax proceeds sufficiently to make it difficult to afford another home several years hence at current inflated prices, even though the actual tax rate on the gains would be 20 percent or less (only 40 percent of the gains would be included in taxable income). Thus, the deferral provision, without the one-time exclusion, could discourage some older taxpayers from selling their homes. On the other hand, the exclusion converts the continuing, interest-free loan on tax liabilities that the deferral provides into a permanent forgiveness of tax liabilities. It thus compounds the favorable tax treatment created by the deferral of capital gains on home sales, and augments the special treatment given housing relative to other types of investment assets.

Rationale

The one-time exclusion is designed to shield older taxpayers from heavy tax burdens when they decide to become renters or move to a less costly residence. It is among the more recent homeownership provisions in the tax code. First introduced in 1964, it applied only to taxpayers 65 or older and then only under special circumstances. Full exclusion was available only when the sale price of the home did not exceed $20,000. For more expensive homes, only a portion of the gain could be excluded. The Revenue Act of 1976 subsequently increased the basic sale price figure to $35,000.

The Revenue Act of 1978 significantly liberalized the exclusion, increasing the amount of excluded gains to $100,000 and allowing all taxpayers 55 and older to claim it. It also reduced the required period of time that a unit had to serve as a taxpayer's principal residence from 5 of the last 8 years to 3 of the last 5. The 1978 act also allowed taxpayers whose previous residence had been "involuntarily converted" (that is, condemned or destroyed) to count toward the 3-year requirement the period spent in a replacement home or apartment. The Economic Recovery Tax Act of 1981 then raised the $100,000 amount to $125,000 ($62,500 in the case of married persons filing separately).

Selected Bibliography

Greenberger, Robert M. "Tax Shelter Possibilities Available When a Principal Residence Is Disposed of by a Client." Taxation for Accountants, v. 24, Mar. 1984: 158–163.

Martin, Mary Lockwood and Robert Nageda II. "Tax Planning Techniques Particularly Applicable to Taxpayers Nearing Retirement." Taxation for Accountants, v. 31, July 1983: 32–37.

U.S. Congress. Congressional Budget Office. *The Tax Treatment of Homeownership: Issues and Options.* 1981.

———. House. Committee on Ways and Means. *General Tax Reform.* Panel Discussions, Part 2—"Capital Gains and Losses" (note particularly the statement by Kenneth B. Sanden, 254).

———. Joint Committee on Taxation. *General Explanation of the Tax Reform Act of 1976.* Dec. 29, 1976: 428–429.

———. *General Explanation of the Economic Recovery Tax Act of 1981.* Dec. 31, 1981: 52.

———. *General Explanation of the Revenue Act of 1978.* Mar. 12, 1979: 255–257.

DEPRECIATION ON RENTAL HOUSING IN EXCESS OF STRAIGHT-LINE, AND DEPRECIATION ON BUILDINGS (Other Than Rental Housing) IN EXCESS OF STRAIGHT-LINE

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	5.7	5.2	10.9
1987	5.6	5.1	10.7
1988	5.5	5.0	10.5
1989	5.6	5.1	10.7
1990	5.9	5.5	11.4
1991	6.1	5.7	11.8

Authorization

Sections 167 (b), (j), and 168.

Description

Taxpayers are allowed to recover the cost of their durable income producing assets that wear out or become obsolete by deducting from gross income an allocable portion of the cost of the assets. Normally these depreciation deductions are spread over the useful life of the asset, and the total amount equals the asset's cost (less salvage value for buildings placed in service by the taxpayer before 1981). Taxpayers are generally offered the choice of using the straight-line method (in which an equal amount of depreciation is deducted each year of the asset's life) or accelerated methods of depreciation (in which greater amounts are deducted in the early years). For buildings placed in service by the taxpayer before 1981, the taxpayer can switch from the declining balance or the sum of the years-digits methods of accelerated depreciation to straight-line depreciation when it becomes advantageous to do so as the asset grows older.

Accelerated depreciation on structures is allowed for all structures placed in service by the taxpayer after 1980. For structures placed in service by the taxpayer before 1981, the use of accelerated depreciation is limited as follows:

Residential Rental Units

(1) New construction may be depreciated under any method allowed by the Internal Revenue Code.

(2) Used buildings having at least a 20-year life when acquiried may be depreciated under the declining balance method using a rate not in excess of 125 percent of the straight-line rate.

Other Structures

(1) New construction may be depreciated by any accelerated method which does not yield depreciation greater than the declining balance method using a rate not exceeding 150 percent of the straight-line rate.

(2) Used buildings may be depreciated on the straight-line method or any other reasonable method that is neither a declining balance or sum of the years digits method.

If a building is sold at a gain, some of the accelerated depreciation will be recaptured as ordinary income. Without recapture rules, all of the gain would be taxed as capital gain. However, the recapture concept is not fully applied to low-income housing.

(See the section on "Real Property" in the description of "Accelerated Depreciation on Equipment Other Than Leased Property," below.)

Example

Assuming a used residential structure was put into service in 1980 with a basis of $10,000, an expected remaining life of 25 years, and no salvage value. If the straight-line method were used, the deduction would be $400 each year. Under accelerated depreciation, the first-year depreciation allowance can be computed as follows:

$$\text{Depreciation allowance} = 125\% \times 1/25 \times \$10{,}000 = \$500$$

In the second year, the depreciation allowance is computed in the same way except the original basis of $10,000 is now reduced by the amount previously depreciated. Hence, the new basis equals $9,500. The second year computation is:

$$\text{Depreciation allowance} = 125\% \times 1/25 \times \$9{,}500 = \$475$$

Thus, in each succeeding year, there is a decrease in the amount of depreciation claimed for tax purposes, and therefore an increase in tax liability compared to what it would be otherwise.

Impact

Because accelerated depreciation allows for larger deductions in the early years of the asset's life and smaller depreciation deductions in the later years, accelerated depreciation results in a deferral of tax liability. It is a tax expenditure to the extent it is faster than economic (i.e., actual) depreciation. It is widely believed to be consistent with actual experience to allow accelerated depreciation for some machinery and equipment which, in many cases, decline in value more rapidly in their early years than later years. However, similar treatment for buildings is generally believed inconsistent with their rates of economic decline in value which are generally much slower than those of machinery and equipment.

The direct benefits of accelerated depreciation for structures accrue to owners of business buildings and rental housing. The benefit is estimated as the tax saving resulting from the depreciation deductions in excess of straight-line depreciation. According to 1978 data, about 81 percent of the tax saving from rental housing and 47 percent of the tax saving from nonresidential buildings accrued to individual owners.

Efforts to repeal accelerated depreciation for real estate have been opposed on the ground that without this treatment, real estate investments would be so unattractive relative to other forms of investment that drastic cutbacks in building would result. On the other hand, it is argued that the tax benefits increase the production of new buildings only to the extent that demand for new buildings responds to small price changes, and that this response is relatively small.

In the Economic Recovery Tax Act of 1981, a new system of accelerated depreciation for structures was enacted. Under the new system (ACRS), generally, structures placed in service on or before March 15, 1984, may be depreciated over 15 years using a prescribed accelerated method which is based on the 175-percent declining balance method (200-percent declining balance for low-income housing). Taxpayers can elect to use the straight-line method over 15 years, 35 years, or 45 years.

The Deficit Reduction Act of 1984 generally increased the recovery period for structures placed in service by the taxpayer after March 15, 1984, from 15 years to 18 years. The change from 15 years to 18 years does not apply to low-income housing.

Rationale

Prior to 1954, depreciation policy had developed through administrative practices and rulings. The straight-line method was favored by IRS and generally used. A ruling issued in 1946 authorized the use of the 150 percent declining balance method. Authorization for it and other accelerated depreciation methods first appeared in legislation in 1954 when the double declining balance and other methods were enacted. The discussion at that time focused primarily on whether the value of machinery and equipment declined faster in their earlier years. However, when the accelerated methods were adopted, real property was included as well, even though it did not decline more rapidly in value in its first years.

By the 1960's, most commentators agreed that accelerated depreciation resulted in excessive allowances for buildings. In 1964, a provision was enacted which "recaptured" accelerated depreciation as ordinary income in varying amounts when a building was sold, depending on the length of time the property was held. However, recapture was not required for straight-line depreciation upon the transfer of real estate. In 1969, the "recapture" provision was strengthened more in the case of commercial real estate which became subject to full recapture, but also to some degree in the case of rental housing. The Tax Reform Act of 1976 provided for complete recapture of subsequent accelerated depreciation for all residential real estate except low-income housing, which continues to receive more liberal treatment.

In the Economic Recovery Tax Act of 1981, the recapture provisions were amended to provide for full recapture of all depreciation on nonresidential structures depreciated under the prescribed accelerated method made available under ACRS. However, if such structures were depreciated using the straight-line method under ACRS, only the accelerated depreciation would be recaptured. The acceleration of depreciation that results from using the 15-year or 18-year recovery period under ACRS is not subject to recapture as accelerated depreciation.

Selected Bibliography

Board of Governors of the Federal Reserve System. *Public Policy and Capital Formation,* Apr. 1981.

Brannon, Gerard M. "The Effects of Tax Incentives for Business Investment: A Survey of the Economic Evidence," in: U.S. Congress. Joint Economic Committee. *The Economics of Federal Subsidy Programs.* Part 3—"Tax Subsidies," July 15, 1972: 245–268.

Break, George F. "The Incidence and Economic Effects of Taxation," in: *The Economics of Public Finance.* Washington, D.C.: The Brookings Institution, 1974.

Bruesseman, William B., Jeffrey D. Fisher and Jerrold J. Stern. "Rental Housing and the Economic Recovery Tax Act of 1981." Public Finance Quarterly, v. 10, Apr. 1982: 222–241.

Deloitte, Haskins, and Sells. *Accelerated Cost Recovery System.* 1981.

Feinberg, Irwin. "ERTA: Winning Hand for Rental Housing." Mortgage Banking, v. 43, Feb. 1983: 44–49.

Feinschreiber, Robert. "New Provisions Increase Depreciation Complexity." Taxes, v. 13, Nov. 1981: 769–775.

Feldstein, Martin. "Adjusting Depreciation in an Inflationary Economy: Indexing Versus Acceleration." National Tax Journal, v. 34, Mar. 1981: 29–43.

Fromm, Gary, ed. *Tax Incentives and Capital Spending.* Washington, D.C.: The Brookings Institution, 1971.

Fullerton, Don and Yolanda Kodrzyzcki Henderson. "Long Run Effects of the Accelerated Cost Recovery System." Discussion Papers in Economics. Paper No. 20, Princeton, N.J.: Princeton University Press, Dec. 1981.

Gravelle, Jane G. "The Capital Cost Recovery System and the Corporate Income Tax." Multilith No. 79-230E. Washington, D.C.: The Library of Congress, Congressional Research Service, Nov. 26, 1979.

———. "Depreciation Policy Options." Multilith No. 80-182E. Washington, D.C.: The Library of Congress, Congressional Research Service, Oct. 10, 1980.

———. "The New Depreciation System and Investment." Congressional Research Service Review. Washington, D.C.: The Library of Congress, Congressional Research Service, Jan. 1982: 13–14, 22.

———. "Effects of the 1981 Depreciation Revisions on the Taxation of Income from Business Capital." National Tax Journal, v. 35, Mar. 1982: 1-20.

Harberger, Arnold. "Tax Neutrality in Investment Incentives," in: Henry J. Aaron and Michael J. Boskin, eds. *The Economics of Taxation.* Washington, D.C.: The Brookings Institution, 1980: 299-313.

Hendershott, Patric and Sheng-Cheng Hu. "Investment in Producers' Durable Equipment," in: Henry J. Aaron and Joseph A. Pechman, eds. *How Taxes Affect Economic Behavior.* Washington, D.C.: The Brookings Institution, 1981: 85-129.

Hoeflich, Michael H. and James Snedden. "Financing Strategies for Residential Rental Real Estate Under the Economic Recovery Tax Act of 1981." Tax Adviser, v. 13, May 1982: 281-288.

Hulten, Charles, ed. *Depreciation, Inflation, and the Taxation of Income From Capital.* Washington, D.C.: The Urban Institute, 1981.

Hulten, Charles and Frank C. Wykoff. "Economic Depreciation and Accelerated Depreciation: An Evaluation of the Conable-Jones 10-5-3 Depreciation Proposal." National Tax Journal, v. 34, Mar. 1981: 45-60.

DeLeeuw, Frank and Larry Ozanne. "Housing," in: Henry J. Aaron and Joseph A. Pechman, eds. *How Taxes Affect Economic Behavior.* Washington, D.C.: The Brookings Institution, 1981: 283-326.

Sheffrin, Steven M. "The Simple Economics of the Liberalized Leasing Provisions." University of California at Davis. Working Paper No. 180, Oct. 1981.

Sunley, Emil M. "The Analytics of Safe Harbor Leases." Tax Notes, v. 13, Nov. 23, 1981: 1219-1222.

Surrey, Stanley S. *Pathways to Tax Reform.* Chapter VII—"Three Special Tax Expenditure Items: Support to State and Local Governments, to Philanthropy, and to Housing." Cambridge, Mass.: Harvard University Press, 1973.

Taubman, Paul and Robert Rasche. "Subsidies, Tax Law, and Real Estate Investment," in: U.S. Congress. Joint Economic Committee. *The Economics of Federal Subsidy Programs.* Part 3—"Tax Subsidies." July 15, 1972: 343-369.

U.S. Congress. Congressional Budget Office. *Real Estate Tax Shelter Subsidies and Direct Subsidy Alternatives.* May 1977.

———. Joint Committee on Taxation. *General Explanation of the Economic Recovery Tax Act of 1981.* Dec. 31, 1981: 67-110.

———. *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984.* Committee Print. 98th Cong., 2nd sess., Dec. 31, 1984: 325-332.

U.S. General Accounting Office. *Investment Tax Credit: Unresolved Issues.* Report to the Congress by the Comptroller General of the United States. PAD-78-40, May 8, 1978.

(370) Commerce and Housing Credit

ACCELERATED DEPRECIATION ON PROPERTY OTHER THAN LEASED PROPERTY

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	2.6	17.7	20.3
1987	2.1	14.8	16.9
1988	1.8	13.9	15.7
1989	1.8	14.2	16.0
1990	1.8	14.8	16.6
1991	1.9	15.4	17.3

A. ACCELERATED COST RECOVERY SYSTEM

Authorization

Section 168.

Description

The Economic Recovery Act of 1981 replaced the prior law depreciation system with the Accelerated Cost Recovery System (ACRS). In general, ACRS applies to property placed in service after December 31, 1980.

ACRS is a system for recovering capital costs using accelerated methods over predetermined periods that are generally unrelated to, but shorter than, prior law useful lives. The ACRS methods of cost recovery and recovery periods are the same for both new and used property.

ACRS is mandatory for all eligible property. The recovery allowance provided under section 168 is deemed a reasonable allowance for depreciation under section 167(a), and eligible property may not be depreciated under the prior law rules of section 167. Thus, accelerated depreciation methods permitted under section 167 cannot be used for ACRS eligible property, and useful lives based on facts and circumstances or the ADR system cannot be used.

Special rules are provided to prevent the churning of used property between certain persons solely to obtain the increased investment incentives under ACRS. Property subject to these antichurning rules is not eligible for ACRS and must be depreciated under the depreciation rules in effect prior to 1981.

Personal Property

Under the new system, the cost of eligible personal property must be recovered over a 15-year, 10-year, 5-year, or 3-year period, depending on the type of property. Most eligible personal property is in the 5-year class. Cars, light-duty trucks, research and experimentation equipment, and certain other short-lived property are in the 3-year class. The 10-year class includes certain long-lived utility property, railroad tank cars, coal-utilization property, and certain real property described in section 1250(c). Other long-lived public utility property is in a 15-year class.

In general, the recovery deduction in each year of the recovery period is determined by applying a statutory percentage to the unadjusted basis of the property. In determining the annual deduction, the applicable percentage to be applied to the unadjusted basis of the property depends on the property's class and the number of years since the property was placed in service by the taxpayer ("recovery year"). The recovery deduction for the taxable year in which property is placed in service is based on the full recovery percentage prescribed in the statutory taxable for the first recovery year, regardless of when the property was placed in service during the taxable year. No recovery deduction is allowable in the year of an asset's disposition.

The schedules for personal property were developed to approximate the benefits of using the 150-percent declining balance method for the early recovery years and the straight-line method for the later recovery years. The schedule reflects the allowance of only a half-year of depreciation for the first recovery year and the allowance of the remaining recovery deductions over the remaining recovery years.

Taxpayers may use, in lieu of the prescribed accelerated percentages, percentages based on the straight-line method over the regular recovery period for the class or one of the two optional longer recovery periods for the class, as described above. Thus, a taxpayer can elect to use the straight-line method over 3 years, 5 years, or 12 years, for 3-year property, 5 years, 12 years, or 25 years for 5-year property; 10 years, 25 years, or 35 years for 10-year property; and 15 years, 35 years, or 45 years for 15-year public utility property.

Real Property

Real property placed in service by the taxpayer on or before March 15, 1984, has a 15-year recovery period. Real property (other than low-income housing) placed in service by the taxpayer after March 15, 1984, has an 18-year recovery period. As an option to the 15-year or 18-year recovery period, taxpayers may elect a 35-year or 45-year extended recovery period and the straight-line method. The election may be made on a property-by-property basis.

The taxpayer has an option to use (1) prescribed percentages based on an accelerated method over the regular 15-year or 18-year recovery period, or (2) the straight-line method over either the regular 15-year or 18-year period, or (3) the optional longer recovery period chosen.

The accelerated percentages are to be determined under tables prescribed by the Department of the Treasury in accordance with the use of the 175 percent declining balance method (200 percent for low-income housing as defined in section 1250(a)(1)(B) (i), (ii), (iii), or (iv)), switching to the straight-line method at a time to maximize the recovery allowance. For the year of acquisition and disposition, the percentages are to be based on the number of months during those years that the property was in service.

Impact

ACRS represents a major change in the concept underlying the methods of cost recovery. The underlying concept of depreciation had been to match deductions for the cost of the assets with the income produced by their use. This objective was accomplished by recovery costs over useful lives as the assets declined in value. In general, the methods used were designed to accord with the actual pattern of loss of economic usefulness, although in practice the rates often varied from the actual rate of decline of the asset.

ACRS abandons the notion of matching income with the cost to produce that income. Instead, ACRS permits costs to be written off using fixed periods at a rate that is significantly faster, in general, than the rate under prior law depreciation or the rate based on the actual decline in value of the asset. ACRS is intended to provide an investment or capital formation stimulus rather than a net income determination. In that sense, ACRS is similar to the investment credit. The subsidy value of ACRS is the tax saving from permitting costs to be written off at a rate faster than the actual decline in value of the asset.

Rationale

In enacting ACRS, Congress concluded that prior law rules for determining depreciation allowances needed to be replaced because they did not provide the investment stimulus that was felt to be essential for economic expansion.

The real value of depreciation deductions allowed under prior rules has declined for several years due to successively higher rates of inflation. Reductions in the real value of depreciation deductions diminish the profitability of investment and discourage businesses from replacing old equipment and structures with more modern assets that reflect recent technology. The Congress concluded that a new capital cost recovery system was required to provide for more rapid acceleration of cost recovery deductions.

The Congress also felt that the prior law rules were too complex. These rules required determinations on matters, such as useful life and salvage value, which are inherently uncertain and, thus, too frequently resulted in unproductive disagreements between taxpayers and the Internal Revenue Service. Regulations under the prior rules provided numerous elections and exceptions which taxpayers—especially, small businesses—found difficult to master and expensive to apply. The Congress decided that a new capital cost recovery system should be structured which de-emphasized the concept of useful life, minimized the number of elections and exceptions, and made compliance and administration easier.

B. ASSET DEPRECIATION RANGE

Authorization

Section 167(m); Regulation 1.167(a)-11; Rev. Proc. 72-10.

Description

The Internal Revenue Service has established useful lives for classes of depreciable assets. The asset depreciation range (ADR) system permits taxpayers to choose any useful life within a range of 20 percent more or less than the class life otherwise established by the IRS for a particular asset. If ADR is chosen, the taxpayer is not required to justify retirement and replacement policies, nor to show that the useful lives selected for the assets are consistent with their actual useful lives.

Under the Economic Recovery Tax Act of 1981, the ADR system generally was repealed for property placed in service after 1980 and was replaced by a new system of accelerated cost recovery known as ACRS. Thus, the ADR system applies only to property placed in service by the taxpayer before 1981 and certain property placed in service after 1980 that is subject to "antichurning" rules under ACRS.

Example

Assume that a taxpayer has a $1,500 asset for which the class life established by the Internal Revenue Service is 10 years. Using double declining balance depreciation without ADR, the deduction in the first year would be 200 percent×.10×$1,500=$300. After deduction of this depreciation charge, the adjusted basis of the asset is $1,200 ($1,500−$300). In the second year, the deduction would be 200 percent×.10−$1,200=$240.

Under the asset depreciation range, a useful life of between 8 and 12 years may be selected. If the taxpayer chooses 8 years, the first-year deduction would be 200 percent×⅛×$1,500=$375. In the second year, the deduction would be 200 percent×⅛×$1,125=$281.25. Therefore, the use of ADR would result in additional deductions of $75 the first year ($375−$300) and $41.25 the second year ($281.25−$240.00).

Selected Bibliography

Board of Governors of the Federal Reserve System. *Public Policy and Capital Formation.* Apr. 1981.

Brannon, Gerard M. "The Effects of Tax Incentives for Business Investment: A Survey of the Economic Evidence," in: U.S. Congress. Joint Economic Committee. *The Economics of Federal Subsidy Programs.* Part 3—"Tax Subsidies," July 15, 1972: 245-268.

Break, George F. "The Incidence and Economic Effects of Taxation," in: *The Economics of Public Finance.* Washington, D.C.: The Brookings Institution, 1974.

Deloitte, Haskins, and Sells. *Accelerated Cost Recovery System.* 1981.

Feinschreiber, Robert. "New Provisions Increase Depreciation Complexity." Taxes, v. 59, Nov. 1981: 769-775.

Feldstein, Martin. "Adjusting Depreciation in an Inflationary Economy: Indexing Versus Acceleration." National Tax Journal, Mar. 1981.

Fromm, Gary, ed. *Tax Incentives and Capital Spending.* Washington, D.C.: The Brookings Institution, 1971.

Fullerton, Don and Yolanda Kodrzyzcki Henderson. "Long Run Effects of the Accelerated Cost Recovery System." Discussion Papers in Economics. Paper No. 20, Princeton, N.J.: Princeton University Press, Dec. 1981.

Gravelle, Jane G. "The Capital Cost Recovery System and the Corporate Income Tax." Multilith No. 79-230E. Washington, D.C.: The Library of Congress, Congressional Research Service, Nov. 26, 1979.

———. "Depreciation Policy Options." Multilith No. 80-182E. Washington, D.C.: The Library of Congress, Congressional Research Service, Oct. 10, 1980.

———. "The New Depreciation System and Investment." Congressional Research Service Review. Washington, D.C.: The Library of Congress, Congressional Research Service, Jan. 1982: 13–14, 22.

———. "Effects of the 1982 Depreciation Revisions on the Taxation of Income from Business Capital." National Tax Journal, v. 35, Mar. 1982: 1-20.

Harberger, Arnold. "Tax Neutrality in Investment Incentives," in: Henry J. Aaron and Michael J. Boskin, eds. *The Economics of Taxation.* Washington, D.C.: The Brookings Institution, 1980: 299-313.

Henderschott, Patric and Sheng-Cheng Hu. "Investment in Producers' Durable Equipment," in: Henry J. Aaron and Joseph A. Pechman, eds. *How Taxes Affect Economic Behavior.* Washington, D.C.: The Brookings Institution, 1981: 85–129.

Hulten, Charles, ed. *Depreciation, Inflation and the Taxation of Income from Capital.* Washington, D.C.: The Urban Institute, 1981.

Hulten, Charles and Frank C. Wykoff. "Economic Depreciation and Accelerated Depreciation: An Evaluation of the Conable-Jones 10-5-3 Depreciation Proposal." National Tax Journal, Mar. 1981: 45-60.

McCabe, John J. "ACRS—After the First Year." 41st Annual Institute on Federal Taxation, New York University, New York, N.Y., 1983: 9-1-9-46.

Ott, Mack. "Depreciation, Inflation and Investment Incentives: The Effects of the Tax Acts of 1981 and 1982." Federal Reserve Bank of St. Louis Review, v. 66, Nov. 1984: 17-30.

U.S. Congress. Joint Committee on Taxation. *General Explanation of the Economic Recovery Tax Act of 1981.* Dec. 31, 1981: 67-110.

———. *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984.* Committee Print. 98th Cong., 2d sess., Dec. 31, 1984: 325-342.

———. *General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982.* Committee Print. 97th Cong., 2d sess., Dec. 31, 1984: 39-40.

(370) Commerce and Housing Credit

AMORTIZATION OF BUSINESS START-UP COSTS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	0.3	(1)	0.3
1987	.2	(1)	.2
1988	.2	(1)	.2
1989	.2	(1)	.2
1990	.2	(1)	.2
1991	.2	(1)	.2

---

[1] Less than $50 million.

Authorization

Section 195.

Description

Costs incurred before the beginning of a business normally are not deductible, because they are not incurred in carrying on a trade or business. These start-up costs normally must be capitalized and added to the taxpayer's basis in the business. Under section 195, a taxpayer may elect to deduct eligible start-up expenditures over a period of not less than 60 months. In the absence of such an election, no deduction is allowed for start-up expenditures.

An expenditure must satisfy two requirements to qualify for this treatment. First, it must be paid or incurred in connection with creating, or investigating the creation or acquisition of, a trade or business entered into by the taxpayer, or in connection with a profit-seeking or income-producing activity prior to the day the taxpayer begins an active trade or business. Second, the expenditure must be one that would have been deductible for the taxable year in which it was paid or incurred, if it had been paid or incurred in connection with the operation of an existing trade or business in the same field as that entered into by the taxpayer.

Impact

The election to amortize business start-up costs encourages the formation of new businesses by permitting the deduction of expenses that would have been deductible by an ongoing business. Without such an election, most of these start-up costs would not be recovered by the taxpayer until the taxpayer sold his interest in the business.

Rationale

Before enactment of section 195 in 1980, the question of whether an expense incurred in creating or investigating the creation of a new business was currently deductible or must be capitalized was a source of controversy and litigation between taxpayers and the Internal Revenue Service. Certain business organizational expenditures for the formation of a corporation or partnership could be amortized, on an elective basis, over a period of not less than 60 months (Code sections 248 and 709).

In 1980, Congress added section 195 in order to encourage the creation of new businesses and reduce the controversy and litigation that surrounded the proper income tax classification of start-up expenditures. In 1984, these rules were clarified to reduce any remaining controversy regarding the definition of start-up expenditures.

Selected Bibliography

U.S. Congress. House. Committee on Ways and Means. *Miscellaneous Revenue Act of 1980.* Report No. 96-1278: 9-13.

———. Joint Committee on Taxation. *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984.* Committee Print. 98th Cong., 2nd sess., Dec. 31, 1984: 295-297.

Wilcox, Gary B. "Start-Up Cost Treatment Under Section 195: Tax Disparity in Disguise." Oklahoma Law Review, v. 36, spring, 1983: 449-466.

(370) Commerce and Housing Credit

CAPITAL GAINS OTHER THAN AGRICULTURE, TIMBER, IRON ORE, AND COAL

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	NA		NA
1987	33.5		33.5
1988	38.4		38.4
1989	43.4		43.4
1990	48.9		48.9
1991	55.2		55.2

Authorization

Sections 1201-1256.

Description

Gains on the sale of capital assets held for more than 6 months are subject to preferentially lower tax rates (see Appendix C). Also, gain on the sale of property used in a trade or business is treated as a long-term capital gain if all gains for the year on such property exceed all losses for the year on such property. Qualifying property used in a trade or business generally is depreciable property or real estate that is held more than 6 months, but not inventory.

For individual taxpayers, only 40 percent of long-term capital gains is included in income, which makes the maximum tax rate for such income 20 percent.

For corporate taxpayers, long-term capital gains generally require a dual tax computation. They are first included in income, and tax on the total income, including the capital gain, is computed using the regular rates. In the alternative computation, a tax on all income other than long-term capital gain is computed at regular rates. The long-term capital gain is taxed at a 28-percent rate, and the two resulting taxes are added together to yield the alternative tax. The lower of the tax computed the regular way or the alternative tax is the tax liability. Thus, a corporation must include the full amount of net long-term capital gains in taxable income, but may apply the special 28-percent alternative capital gain tax rate on the gain.

Gain on most depreciable tangible personal property used in a trade or business will be treated as ordinary income to the extent it arises from depreciation that has been allowed after 1961, i.e., the depreciation is recaptured; but only some depreciation on real estate is recaptured.

The untaxed portion of capital gains is the principal tax expenditure subject to the minimum tax for tax preferences. This additional tax may offset a portion of the benefits of capital gains taxation for individuals and corporations with substantial annual capital gains.

Example

To illustrate the calculation of capital gains taxation for corporations, assume a corporation has, for the taxable year 1985, taxable income of $250,000, which includes net long-term capital gains of $60,000.

Tax computed in regular manner:	
Taxable income	$250,000
Tax	94,750
Alternative tax:	
Partial tax on $190,000 ($250,000 minus $60,000)	67,150
28 percent of $60,000	16,800
Alternative tax	83,950

The alternative tax is $10,800 less than the regular tax, and in this example the tax expenditure is the tax savings attributable to the alternative tax computation.

Impact

For individuals, the deduction from gross income of 60 percent of capital gains results in tax rates of 40 percent of the normal rates. The tax treatment of capital gains increases the after-tax earnings on assets, and thereby may encourage individuals to invest in assets which may appreciate in value. Furthermore, the tax preference may reduce the inhibiting effects of taxation on the sale of assets.

The benefits of this provision are concentrated among high income individuals, with approximately two-thirds of the benefit received by those with expanded gross incomes of $100,000 or more. The tax saving per dollar of capital gain increases with the tax bracket of the taxpayer.

Corporations with taxable income over $50,000 that realize income from the sale of long-term capital assets are the direct corporate beneficiaries of the general capital gains rules.

According to 1977 tax return data, net capital gains taxed at alternative rates averaged 5.6 percent of taxable income for all corporations. Aside from farming and timber, iron ore, and coal to which special capital gains rules apply, industries which had a high ratio of capital gains to ordinary income were real estate companies, and investment companies.

In cases in which the minimum tax applies to offset some of the benefits of capital gains taxation, it generally will increase the maximum rate on capital gains by slightly more than 4 percentage points for corporations.

Rationale

Although the original 1913 income tax law taxed capital gains at ordinary rates, the 1921 law provided for an alternative flat rate tax for individuals of 12.5 percent. This treatment was to minimize the influence of the high progressive rates on market transactions. The Committee Report noted that these gains are earned over a period of years, but are nevertheless taxed as a lump sum. Over the years many revisions in this treatment have been made, including the temporary adoption of a sliding scale treatment (where lower rates applied the longer the asset was held) and an alternative capital gains rate for individuals which was repealed in 1978. Both the minimum tax on preference income and the maximum tax offset, which raise the capital gains rate for a limited number of taxpayers with capital gains, were first enacted in 1969 and then strengthened in 1976.

Prior to 1942, corporate capital gains were taxed in the same manner as ordinary corporate income. The 1942 act also introduced the alternative tax for corporations at a 25-percent rate, the alternative tax rate then in effect for individuals. This tax relief was premised on the belief that many wartime sales were involuntary conversions which could not be replaced during wartime, and that resulting gains should not be taxed at the greatly escalated wartime rates.

The alternative rate was raised to 30 percent in 1969 and lowered to 28 percent in 1978. The 28-percent rate adopted in 1978 was intended to apply the same maximum marginal rate to capital gains of corporations as applied to individuals.

Further Comment

Many reasons have been advanced for preferential treatment of capital gains income of individuals, with the major ones being: (1) capital gains are accrued over a long period of time, and should not be subject to tax under progressive rates as a lump sum; (2) capital gains reflect inflation to a substantial extent and are thus not real income; and (3) because an asset owner has discretion as to when to realize gains, the application of ordinary tax would act as a barrier to transactions in the capital market and lead to lock-in effects (asset owners refrain from selling because of the tax), with attendant distorting effects on savings, investment, and economic efficiency.

On the other hand, the following arguments have been advanced against the preferential treatment of capital gains: (1) even if capital gains were taxed as ordinary income, the advantage remains of the deferral of tax on unrealized gains; (2) inflation affects returns on assets in general, not just capital gains transactions; (3) the lock-in problem might be resolved in other ways, such as taxing gains transferred at death (thus removing the opportunity to avoid capital gains taxes entirely); and (4) the bunching problem can be met by a special averaging provision.

The effect of the difference in tax rates on ordinary income versus capital gains is different for corporations and individuals for a number of reasons. More of the capital gain for corporations results from sales in the normal course of business. Further, the ability to exempt gains from tax by death transfers is not available for corporations. Finally, there is less of a bunching problem for corporations since the corporate tax is graduated to a limited extent.

Selected Bibliography

Bailey, Martin J. "Capital Gains and Income Taxation," in: Arnold Harberger and Martin Bailey, eds. *The Taxation of Income From Capital.* Washington, D.C.: The Brookings Institution, 1969: 11-49.

Bartlett, Bruce. *The Federal Tax Debate: Capital Gains.* Washington, D.C.: Heritage Foundation, 1984.

Brinner, Roger and Alicia Munnell. "Taxation of Capital Gains: Inflation and Other Problems." New England Ecnomic Review. Federal Reserve Bank of Boston, Sept.-Oct. 1974: 3-21.

David, Martin. *Alternative Approaches to Capital Gains Taxation.* Washington D.C.: The Brookings Institution, 1968.

Martin, David and Roger Miller. "The Lifetime Distribution of Realized Capital Gains," in: U.S. Congress. Joint Economic Committee. *The Economics of Federal Subsidy Programs.* Part 3—"Tax Subsidies," July 15, 1972: 269-285.

Feldstein, Martin, et al. "The Effect of Taxation on the Selling of Corporate Stock and the Realization of Gains." Quarterly Journal of Economics, v. 94, June 1980: 777-791.

Fredland, J. Eric, et al. "The Six-Month Holding Period for Capital Gains: An Empirical Analysis of Its Effect on the Timing of Gains." National Tax Journal, v. 21, Dec. 1968: 467-478.

Gravelle, Jane G. *Capital Gains Taxes: Issues and Proposals.* Washington, D.C.: The Library of Congress, Congressional Research Service, Sept. 1, 1978.

Holt, Charles C. and John P. Shelton. "The Lock-In Effect of the Capital Gains Tax." National Tax Journal, v. 15, Dec. 1962: 337-352.

Kotlikoff, Lawrence J. *Taxation and Savings—A Neoclassical Perspective.* Cambridge, Mass.: National Bureau of Economic Research, 1984.

Minarik, Joseph J. "Capital Gains," in: Henry J. Aaron and Joseph A. Pechman, eds. *How Taxes Affect Economic Behavior.* Washington, D.C.: The Brookings Institution, 1981: 241-281.

Seltzer, Lawrence H. *The Nature and Tax Treatment of Capital Gains and Losses.* New York: National Bureau of Economic Research, 1951.

Slemrod, Joel. "The Effect of Capital Gains Taxation on Year End Stock Market Behavior." National Tax Journal, v. 35, Mar. 1982: 69-78.

Stiglitz, Joseph, E. *Some Aspects of the Taxation of Capital Gains.* Cambridge, Mass.: National Bureau of Economic Research, 1983.

U.S. Congress. House. Committee on Ways and Means. *Federal Tax Treatment of Capital Gains and Losses.* Hearing. 98th Cong., 1st sess., Nov. 2, 1983.

——. Joint Committee on Taxation. *General Explanation of the Revenue Act of 1978,* Mar. 12, 1979: 251–275.

——. *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984.* Committee Print. 98th Cong., 2d sess., December 31, 1984: 1083–1085.

Wetzler, James W. "Capital Gains and Losses," in: Joseph Pechman, ed. *Comprehensive Income Taxation.* Washington, D.C.: The Brookings Institution, 1977: 115–162.

Woo, Mai Nguyen. "How Far Can Gains Tax Rates Be Cut Without Loss of Revenue?" Tax Notes, v. 11, May 11, 1981: 1027–1031.

(370) Commerce and Housing Credit

CAPITAL GAINS AT DEATH

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	4.0		4.0
1987	4.4		4.4
1988	5.0		5.0
1989	5.5		5.5
1990	6.1		6.1
1991	6.8		6.8

Authorization

Sections 1001, 1002, 1014, 1015, 1023, 1040, 1221, and 1222.

Description

A capital gains tax generally is imposed on the increased value of a capital asset when the asset is sold or exchanged. However, this tax is not imposed on the appreciation in value when ownership of the property is transferred as a result of the death of the owner or as a gift during the lifetime of the owner. In the case of assets transferred at death, the heir's basis in the asset generally is the fair market value as of the date of decedent's death. Thus, no income tax is imposed on appreciation occurring before the decedent's death. In the case of gift transfers, the donee's basis in the property is the same as the donor's. Thus, if the donee disposes of the property in a sale or exchange, the capital gains will apply to the pretransfer appreciation.

Assets transferred at death or by *inter vivos* gift may be subject to the Federal estate and gift taxes, respectively, based upon their value at the time of transfer.

Impact

The exclusion of capital gains at death is most advantageous to individuals who need not dispose of their assets to achieve financial liquidity. Generally speaking, these tend to be wealthier individuals. The deferral of tax on the appreciation involved combined with the exemption for the appreciation before death is a significant benefit for these investors and their heirs.

Failure to tax capital gains at death encourages lock-in of assets, which in turn means less current turnover of funds available for investment. In deciding whether to change his portfolio, an investor takes into account the higher pretax rate of return he might obtain from the new investment, the capital gains tax he might have to pay if he changes his portfolio, and the capital gains tax his heirs might have to pay in the future if he decides not to change his portfolio. Often an investor in this position decides that, since his heirs will incur no capital gains tax on appreciation that occurs before the investor's death, he should transfer his portfolio unchanged to the next generation. The lack of a tax on capital gains transferred at death or by gift provides a further incentive to this option. To the extent this option is taken, taxpayers are said to be locked-in to investments.

Rationale

The original rationale for nonrecognition of capital gains on *inter vivos* gifts or transfers at death is not indicated in the legislative history of any of the several interrelated applicable provisions. However, one current justification given for the treatment is that death and *inter vivos* gifts are considered as inappropriate events to result in the recognition of income.

The Tax Reform Act of 1976 provides that the heir's basis in property transferred at death would be determined by reference to the decedent's basis. This carryover basis provision was not permitted to take effect and was repealed in 1980. The primary rationale for repeal was the concern that carryover basis created substantial administrative burdens for estates, heirs, and the Treasury Department.

Further Comment

Taxation of capital gains at death would cause liquidity problems for some taxpayers, such as owners of small farms and businesses. Therefore, most proposals for taxing capital gains at death would combine substantial averaging provisions, deferred tax payment schedules, and a substantial deductible floor in determining the amount of gain to be taxed.

Selected Bibliography

Bailey, Martin J. "Capital Gains and Income Taxation," in: Arnold Harberger and Martin Bailey, eds. *The Taxation of Income From Capital.* Washington, D.C.: The Brookings Institution, 1969: 11-49.

Brinner, Roger and Alicia Munnell. "Taxation of Capital Gains: Inflation and Other Problems." New England Economic Review. Federal Reserve Bank of Boston, Sept.-Oct. 1974: 3-21.

David, Martin. *Alternative Approaches to Capital Gains Taxation.* Washington, D.C: The Brookings Institution, 1968.

David, Martin and Roger Miller. "The Lifetime Distribution of Realized Capital Gains," in: U.S. Congress. Joint Economic Committee. *The Economics of Federal Subsidy Programs,* Part 3—"Tax Subsidies." July 15, 1972: 269-285.

Feldstein, Martin, et al. "The Effect of Taxation on the Selling of Corporate Stock and the Realization of Gains." Quarterly Journal of Economics, v. 94, June 1980: 777-791.

Holt, Charles C. and John P. Shelton. "The Lock-In Effect of the Capital Gains Tax." National Tax Journal, v. 15, Dec. 1962: 337-352.

Minarik, Joseph J. "Capital Gains," in: Henry J. Aaron and Joseph A. Pechman, eds. *How Taxes Affect Economic Behavior.* Washington, D.C.: The Brookings Institution, 1981: 241-281.

Seltzer, Lawrance H. *The Nature and Tax Treatment of Capital Gains and Losses.* New York: National Bureau of Economic Research, 1951.

Surrey, Stanley S., et al., eds. "Taxing Capital Gains at the Time of a Transfer at Death or by Gift," in: *Federal Tax Reform for 1976.* Washington, D.C.: Fund for Public Policy Research, 1976: 107-114.

U.S. Congress. House. Committee on Ways and Means. *Federal Tax Treatment of Capital Gains and Losses.* Hearing. 98th Cong., 1st sess., Nov. 2, 1983.

———. Joint Committee on Taxation, *General Explanation of the Revenue Act of 1978,* Mar. 12, 1979: 251-275.

———. Senate. Committee on Finance. *Estate and Gift Taxes: Problems Arising from the Tax Reform Act of 1976.* Hearing. 95th Cong., 1st sess., July 25, 1977.

Wagner, Richard E. *Inheritance and the State.* Washington, D.C.: American Enterprise Institute for Public Policy Research, 1977.

Westfall, David. "The Taxation of Unrealized Appreciation at Death." Tax Notes, v. 4, May 3, 1976: 5-11.

Wetzler, James W. "Capital Gains and Losses," in: Joseph Pechman, ed. *Comprehensive Income Taxation.* Washington, D.C.: The Brookings Institution, 1977: 115-162.

Woo, Mai Nguyen. "How Far Can Gains Tax Rates Be Cut Without Loss of Revenue?" Tax Notes, v. 11, May 11, 1981: 1027-1031.

(370) Commerce and Housing Credit

NON-RECOGNITION OF GAIN ON PROPERTY DISTRIBUTION IN LIQUIDATION

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	NA	NA	NA
1987	−0.4	4.5	4.1
1988	−.5	5.3	4.8
1989	−.5	5.9	5.4
1990	−.6	6.3	5.7
1991	−.6	6.6	6.0

Authorization

Sections 336, 337, and 338.

Description

The complete liquidation of a corporation is generally a taxable event on its shareholders. However, with several important exceptions, it is not a taxable event to the corporation. As a result, a corporation holding assets that have appreciated in value can liquidate without that appreciation ever being taxed at the corporate level.

A similar rule applies to certain liquidating sales by corporations. Under section 337, a corporation can adopt a plan of complete liquidation, sell its appreciated assets, and then liquidate. While the corporation's shareholders will be taxed on the liquidation, the transaction will not be taxable to the corporation, again with several important exceptions. As a result, the appreciation will not be taxed at the corporate level.

Section 338 generally applies when one corporation buys at least 80 percent of the stock of another corporation. When it applies, section 338 permits taxpayers to treat the corporation the stock of which has been acquired as having sold all its assets in a transaction to which section 337 applies. When such an election is made, appreciation in value of that corporation's assets generally goes untaxed at the corporate level. However, selling shareholders of that corporation will have a taxable event.

Impact

In theory, corporate income is subject to two levels of income taxation, once when earned by the corporation and once when distributed to its shareholders. Sections 336, 337, and 338 permit, in the case of certain extraordinary events regarding corporations, an elimination of one level of taxation. One effect of those rules is to increase the price a buyer will pay for a corporation over what would be paid in the absence of those rules.

Rationale

The rationale behind the rules of sections 336, 337, and 338 may be disputed. Historically, they stem from a series of cases, including *General Utilities and Operating Co.* v. *Helvering,* 296 U.S. 200 (1935). Today, some view them as sound tax policy. The primary tax policy argument is that when a corporation undergoes an extraordinary event, such as a liquidation, a liquidating sale, or a sale of its stock, imposing two levels of tax would be too onerous.

Further Comment

In recent years, there has been a large volume of activity involving the acquisition of public companies. Many attribute much of that activity to the fact that the stock of such companies sells over the stock exchange at a substantial discount from real net asset value. It is possible that the tax laws contribute significantly to that fact. Thus, the value of a corporation that, in effect, can earn substantial income without paying a corporate-level tax will exceed the value of the same corporation that must pay a corporate-level tax on its income.

Selected Bibliography

Amdur, Martin B. "Federal Income Tax Treatment of the Parties to a Taxable Stock Acquisition: The Impact of TEFRA." 41st Annual Institute on Federal Taxation, New York University, New York, N.Y., 1983: 51A-1—51A-21.

Battle, Frank V., Jr. "Section 338—Stock Purchases Treated as Asset Purchases for Tax Purposes." Taxes, v. 60, 1982: 980-984.

Gately, Mary Sue and Craig J. Langstraat. "Tax Consequences of Acquiring Appreciated Assets Through a Stock Purchase." Gonzaga Law Review, v. 19, 1983/1984: 315-331.

Ginsburg, Martin D. "Taxing Corporate Acquisitions." Tax Law Review, v. 38, winter 1983: 171-256.

Heinkel, R. Lawrence. "Section 338—An Analysis and Proposals for Reform." Notre Dame Law Review, v. 59, 1983: 158-186.

Silverman, Mark J. and Susan H. Sterling. "An Analysis of the TEFRA Changes Affecting Corporate Distributions and Acquisitions." Journal of Taxation, v. 57, Nov. 1982: 274-280.

U.S. Congress. Joint Committee on Taxation. *General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982.* Committee Print. 97th Cong., 2d sess., Dec. 31, 1984: 131-140.

Ward, Larry D. "The TEFRA Amendments to Subschapter C: Corporate Distributions and Acquisitions." Journal of Corporate Law, v. 8, 1983: 277–336.

Weintraub, Irving and Robert M. Brown. "Four Types of Liquidations Provide Different Tax Results to Corporations and Shareholders." Taxation for Accountants, v. 33, Dec. 1984: 376–371.

Yancy, Howard C. "Section 338: The Result of the Legal Evolution of the Tax Treatment of Two-Step Asset Acquisition." Texas Law Review, v. 61, Mar. 1983: 1109–1161.

(370) Commerce and Housing Credit

REDUCED RATES ON THE FIRST $100,000 OF CORPORATE INCOME

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986		8.4	8.4
1987		9.3	9.3
1988		9.6	9.6
1989		9.9	9.9
1990		10.4	10.4
1991		10.9	10.9

Authorization

Section 11.

Description

Corporate taxable income is subject to tax under a five-step graduated tax rate structure. The top corporate tax rate is 46 percent on taxable income over $100,000.

An additional 5 percent corporate tax is imposed on a corporation's taxable income in excess of $1 million until the maximum additional tax is $20,250. Thus, the benefit of the graduated rates is eliminated for corporations with income in excess of $1,405,000.

Taxable income	Tax rate
0 to $25,000	15
$25,000 to $50,000	18
$50,000 to $75,000	30
$75,000 to $100,000	40
$100,000 to $1,000,000	46
$1,000,000 to $1,405,000	51
Over $1,405,000	46

Impact

These reduced rates are available to all corporations. They reduce tax liability from a flat rate 46 percent tax for a corporation with $100,000 of taxable income by $20,250. This tends to neutralize the tax differential between a business operating as a sole proprietorship or a partnership and a corporation by lowering the corporate tax rate on the first $100,000 to rates comparable to the individual rates. The phaseout limits the benefits of the graduated rates to a corporation with taxable income below $1,000,000. As a result, a corporation with taxable income from $1,000,001 to $1,405,000 pays a 51-percent marginal tax rate, which is 5 percentage points greater than the rate on taxable income just below or above this range.

The graduated rates encourage the use of the corporate structure and allow some small corporate businesses that might otherwise operate as sole proprietorships or partnerships to provide fringe benefits. They also encourage the splitting of operations between sole proprietorships, partnerships, and corporations. Most businesses are not incorporated; only about 5 percent of all businesses are affected by this provision, and not all of those receive the full tax benefit because their taxable income is less than $100,000.

Rationale

Since almost the earliest days of the corporate income tax, some level of profits has been exempted from the full corporate tax rate. The split between a normal tax and a surtax was not, however, fully accomplished until the Revenue Act of 1941. The purpose was to provide relief for small businesses. However, many large businesses fragmented their operations into numerous corporations to obtain numerous exemptions from the surtax. Some remedial steps were taken in 1963; in 1969, legislation was enacted limiting groups of corporations controlled by the same interest to a single surtax exemption. Expanded temporary exemptions were first enacted in 1975, and were continued in 1976 and 1977. The present corporate tax rates were enacted in the 1981 Economic Recovery Tax Act and amended in the Deficit Reduction Act of 1984.

Selected Bibliography

Gallagher, Thomas. "Small Business Taxation, Capital Formation, and Innovation." Multilith No. 80-120E. Washington, D.C.: The Library of Congress, Congressional Research Service, Oct. 31, 1980.

Pechman, Joseph A. *Federal Tax Policy*. Fourth edition. Washington, D.C.: The Brookings Institution, 1983: 134.

U.S. Congress. Joint Committee on Taxation. *General Explanation of the Revenue Act of 1978,* Mar. 12, 1979: 143-144.

———. *General Explanation of the Economic Recovery Tax Act of 1981,* Dec. 31, 1981: 143-144.

———. House. Committee on Ways and Means. *Capital Formation.* Committee Print. 94th Cong., 1st sess., Oct. 2, 1975.

———. Committee on Small Business. *Recommendations of Securities and Exchange Commission Forum on Small Business Capital Formation.* Joint hearing before the Subcommittee on Tax, Access to Equity Capital and Business Opportunities, and the Subcommittee on Urban and Rural Economic Development of the Committee on Small Business, United States Senate, 97th Cong., 2nd sess., Dec. 1, 1982.

———. Senate. Committee on Finance. *Impact of the Tax System on Productivity in Small Business and Agriculture.* Hearing. 98th Cong., 2nd sess., May 21, 1984.

INVESTMENT CREDIT, OTHER THAN ESOP's, REHABILITATION OF STRUCTURES, REFORESTATION, LEASING, AND ENERGY PROPERTY

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	5.3	30.5	35.8
1987	5.6	31.2	36.8
1988	6.2	34.6	40.8
1989	6.8	38.3	45.1
1990	7.5	42.3	49.8
1991	8.2	46.4	54.6

Authorization

Sections 38 and 46–48.

Description

The investment tax credit (ITC) is available to any taxpayer who invests in income-producing property that is eligible for the credit.

Eligible investment is largely limited to tangible personal property, such as machinery and equipment, that is used in the United States. Most buildings are not eligible.[1]

The credit is generally 10 percent of the qualified investment. The amount of credit is subtracted from tax liability calculated without the credit. The amount of investment that qualifies for the credit is the full purchase price for property in the 5-year, 10-year, 15-year real property, or 15-year public utility property class under ACRS. For 3-year recovery property under ACRS, only 60 percent of the purchase price is qualified investment. Qualified investment in property that is not eligible property under ACRS is based on the estimated useful life of the property. For property with a useful life of at least 7 years, the full purchase price is qualified investment. Two-thirds of the investment in property with a useful life of 5 to 7 years qualifies for the credit. For property with a useful life of 3 to 5 years, one-third of the investment qualifies for the credit.

---

[1] With exceptions, investments eligible for the credit include eligible property under ACRS and depreciable or amortizable property having a useful life of 3 years or more and include: (1) tangible personal property; (2) other tangible property (not including a building or its components) used as an integral part of (a) manufacturing, (b) extraction, (c) production or (d) furnishing of transportation, communications electrical energy, gas, water or sewage disposal services; (3) elevators and escalators; (4) research facilities and facilities for the bulk storage of fungible commodities and (5) single purpose agricultural structures.

In 1978, the credit was extended to qualified rehabilitation expenditures for nonresidential buildings. In 1981, the used property limitation was increased to $125,000 per year for taxable years 1981–1984, and $150,000 per year for taxable years beginning after 1984. Also, the rehabilitation credit was modified to provide a three-tier system of 15-, 20-, and 25-percent credits.

For taxable years beginning in 1981 through 1987, only $125,000 of investment in used property qualifies for the credit in 1 year. For taxable years beginning after 1987, $150,000 of investment in used property qualifies for the credit in 1 year. For taxable years, before 1981, the used property limitation was $100,000.

For taxable years ending in 1982 and thereafter, the maximum credit that can be claimed in any 1 year is $25,000 plus 85 percent of the tax liability over $25,000. Any unused amount of the credit can be carried back 3 years and carried forward 15 years. For pre-1974 carryovers a 7-year period was allowed. A taxpayer is required to reduce the basis of assets by 50 percent of the regular investment credit and the 25-percent rehabilitation credit. The full amount of the 15- and 20-percent credits for qualified rehabilitation expenditures reduces the building's depreciable basis.

In 1981, an at-risk limitation was imposed on the allowance of the tax credit. For individuals, subchapter S corporations, and certain closely held corporations, the investment credit is allowed only to the extent the investment in eligible property is at risk. An exception is provided for limited nonrecourse financing by certain third-party lenders. Another exception is provided for certain energy property.

Impact

The credit has two effects. First, it reduces the cost of capital and, therefore, can turn an unprofitable investment into a profitable one (or a profitable one into a more profitable one). Assume that an investor requires a 15-percent rate of return to undertake an investment project. A machine which costs $1,000 and provides an annual return of $135 does not meet the 15 percent target. However, since a 10-percent ITC reduces the net cost of the machine to $900, the $135 annual return with the credit meets the 15 percent standard (15 percent of $900=$135). Second, it increases the recipient's cash flow.

While noncorporate businesses and individual investors benefit from the credit, over 80 percent of the credit accrues to corporations. Since the credit is directly related to investment in durable equipment, much of the direct benefit is concentrated in manufacturing and utilities.

According to 1977 tax data, 74 percent of the ITC was claimed by corporations with assets of $250 million or more. Two major industry categories account for 80 percent of the credit; manufacturing (42 percent), and transportation, communication, electric, gas, and sanitary services (38 percent).

For some firms, e.g., public utilities, the credit on an investment may exceed the company's tax liability. Instead of purchasing the property, the firm may find it profitable to lease the equipment from a bank that is able to obtain full benefit from the credit. Securities and Exchange Commission data indicate substantial use of the credit by banks through leasing arrangements.

Several studies have produced little evidence that suggests the past changes in the application of the credit have been effective as *short-run* business cycle stabilization tools. Other studies have produced conflicting evidence as to the *long-run* effectiveness of the credit in stimulating investment which increases the rate of capital accumulation and economic growth.

Rationale

Originally adopted as part of the Revenue Act of 1962, the credit was intended to stimulate investment and economic growth. The credit was also justified as a means of increasing the ability of American firms to compete abroad and of compensating for the effect of inflation on capital replacement. The credit was modified in 1964, suspended in September 1966, restored in March 1967, repealed in April 1969, reenacted in August 1971, temporarily liberalized in March 1975 until the end of 1976, and in 1976, extended at the liberalized rate through 1980.

Selected Bibliography

Auerbach, Alan J. "Corporate Taxation in the United States." *Brookings Papers on Economic Activity,* No. 2, 1983: 451–505.

Bradford, David F. "Tax Neutrality and the Investment Tax Credit," in: Henry J. Aaron and Michael J. Boskin, eds. *The Economics of Taxation.* Washington, D.C.: The Brookings Institution, 1980: 281–298.

Brannon, Gerard M. "The Effects of Tax Incentives for Business Investment: A Survey of the Economic Evidence," in: U.S. Congress. Joint Economic Committee. *The Economics of Federal Subsidy Programs,* Part 3—"Tax Subsidies," July 15, 1972: 245–268.

Break, George F. "The Incidence and Economic Effects of Taxation," in: *The Economics of Public Finance.* Washington, D.C.: The Brookings Institution, 1974.

Brumbaugh, David L. and Jane G. Granvelle. *The Corporate Income Tax and the U.S. Economy.* Multilith No. 84–143E. Washington, D.C.: The Library of Congress, Congressional Research Service, Aug. 24, 1984.

Fromm, Gary, ed. *Tax Incentives and Capital Spending.* Washington, D.C.: The Brookings Institution, 1971.

Gravelle, Jane G. *Assessing Structural Tax Revision With Macro-Economic Models: The Treasury Tax Proposals and the Allocation of Investment.* Report No. 85–645E. Washington, D.C.: The Library of Congress, Congressional Research Service, Apr. 8, 1985.

———. *The Capital Cost Recovery System and the Corporate Income Tax.* Multilith No. 79–230E. Washington, D.C.: The Library of Congress, Congressional Research Service, Oct. 10, 1980.

———. *A Comparative Analysis of Five Tax Proposals: Effects of Business Income Tax Provisions.* Report No. 84–832E. Washington, D.C.: The Library of Congress, Congressional Research Service, Dec. 27, 1984.

———. *"Effects of Business Tax Provisions in the Administration's Tax Proposal: Updated Tables.* Report No. 85-783E. Washington, D.C.: The Library of Congress, Congressional Research Service, June 6, 1985.

———. "Effects of the 1981 Depreciation Revisions on the Taxation of Income From Business Capital." *National Tax Journal,* v. 35, Mar. 1982.

Harberger, Arnold. "Tax Neutrality in Investment Incentives," in: Henry J. Aaron and Michael J. Boskin, eds. *The Economics of Taxation.* Washington, D.C.: The Brookings Institution, 1980: 299-313.

Hendershott, Patric and Sheng-Cheng Hu. "Investment in Producers' Durable Equipment," in: Henry J. Aaron and Joseph A. Pechman, eds. *How Taxes Affect Economic Behavior.* Washington, D.C.: The Brookings Institution, 1981: 85–129.

Hulten, Charles, ed. *Depreciation, Inflation, and the Taxation of Income from Capital.* Washington, D.C.: The Urban Institute, 1981.

U.S. Congress. Congressional Budget Office. *Revising the Corporate Income Tax.* Washington, D.C.: U.S. Government Printing Office, May 1985.

———. Joint Committee on Taxation. *General Explanation of the Economic Recovery Tax Act of 1981.* Committee Print. 97th Cong., 1st sess., Dec. 29, 1981: 67–137.

———. *General Explanation of the Tax Equity and Fiscal Responsibility Act of 1982.* Committee Print. 97th Cong., 2nd sess., Dec. 31, 1984: 35–38.

(370) Commerce and Housing Credit

DIVIDEND EXCLUSION

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	0.6		0.6
1987	.6		.6
1988	.7		.7
1989	.7		.7
1990	.7		.7
1991	.7		.7

Authorization

Section 116.

Description

An individual may exclude dividends of up to $100 ($200 on a joint return without regard to which spouse actually receives the dividends) received from domestic corporations.

Impact

Although this provision benefits all taxpayers who receive dividend income and have tax liability, only a small percentage of total dividends is affected by the provision because of the dollar limitation. The tax saving per dollar of exclusion increases with the taxpayer's marginal tax bracket. In the aggregate, the benefits tend to accrue to middle- and high-income taxpayers because they are more likely to own stock.

Rationale

In 1954 a dividend exclusion of $50 and a credit against tax liability for 4 percent of dividends above that amount were adopted. The stated purpose was to provide partial relief from the double taxation of dividends (the corporate income tax and the individual income tax on dividends) which, it was argued, hampered, the ability of companies to raise capital. The exclusion was stated to be designed to afford greater relief for the low-income investor.

In 1964, although the administration recommended repeal of both the credit and exclusion, the credit was repealed and the exclusion was doubled. The reasons offered were (1) that the provisions had not achieved their objectives, (2) the change would remove the discrimination in favor of high-income taxpayers, (3) the change would encourage broader ownership of stock, and (4) the change would raise revenues that could be used to reduce the individual taxes in general.

Further Comment

As indicated above, the issue that gave rise to the initial enactment of the exclusion and credit is the double taxation of dividends or, more generally, the burden of taxes on capital, and on corporate equity capital in particular. While the exclusion survives, it does relatively little to resolve this problem because of the low dollar ceiling. Many proposals for partial and full integration of the corporate and individual income taxes have been made. Partial integration proposals were seriously considered, but not proposed, by the Carter administration in 1977. They have also been the subject of congressional hearings, and have been discussed in recent years in the House Ways and Means Committee. Finally, the Treasury tax reform proposal released in November 1984 would permit corporations to deduct 50 percent of dividends paid.

Selected Bibliography

Arak, Marcelle. "Inflation and Stock Values: Is Our Tax Structure the Villain?" Federal Reserve Bank of New York Quarterly Review, winter 1980-81: 3-13.

Balcer, Yves. "The Taxation of Capital Gains: Samuelson's Fundamental Principle." Public Finance, v. 38, No. 1, 1983: 1-15.

Becker, Charles and Don Fullerton. "Income Tax Incentives to Promote Savings." National Tax Journal, v. 33, Sept. 1980: 331-351.

Boskin, Michael J. "Taxation, Saving and the Rate of Interest." Journal of Political Economy, Apr. 1978: S3-S27.

Bradford, David F. "The Economics of Tax Policy Toward Saving," in: George von Furstenburg, ed. *The Government and Capital Formation.*

Cambridge, Mass.: Ballinger, 1980: 11-68.

Brinner, Roger E. and Stephen H. Brooks. "Stock Prices," in: Henry J. Aaron and Joseph A. Pechman, eds. *How Taxes Affect Economic Behavior.* Washington, D.C.: The Brookings Institution, 1981: 199-240.

Goode, Richard. *The Individual Income Tax.* Revised edition. Washington, D.C.: The Brookings Institution, 1976: 138-139.

Howrey, E. Philip and Saul H. Hymans. "The Measurement and Determination of Lanable-Funds Saving," in: Joseph A. Pechman, ed. *What Should Be Taxed: Income or Expenditure?* Washington, D.C.: The Brookings Institution, 1980: 1-31.

Jackson, William. "Saving and Rate of Return Incentives: Estimates of the Interest Elasticity of Personal Saving." Multilith No. 81-198E. Washington, D.C.: The Library of Congress, Congressional Research Service, Aug. 31, 1981.

McCure, Charles E., Jr. "Taxes, Saving and Welfare: Theory and Evidence." National Tax Journal, v. 33, Sept. 1980: 311-320.

Musgrave, Richard A. "Tax Policy and Capital Formation." National Tax Journal, v. 29, Sept. 1978: 351-357.

Pechman, Joseph A. "A Genuine Saving Incentive." Tax Notes, v. 13, July 6, 1981: 7-8.

———. *Federal Tax Policy.* Fourth edition. Washington, D.C.: The Brookings Institution, 1983: 171-180.

Stein, Herbert and Murray F. Foss. "Taxes and Saving." The AEI Economist, July 1981: 1-6.

Talley, Louis A. "Interest Income Exclusion From Individual Income Taxes: Economic Analysis and Preliminary Revenue Estimates." Multilith No. 79-205E. Washington, D.C.: The Library of Congress, Congressional Research Service, Sept. 24, 1979.

Tanzi, Vito. "Inflation and the Incidence of Income Taxes on Interest Income: Some Results for the United States, 1972-74." International Monetary Fund Staff Papers, July 1977: 500-513.

"The Taxation of Income From Corporate Shareholding." Symposium sponsored by the National Tax Association—Tax Institute of America and Fund for the Public Policy Research. National Tax Journal, Sept. 1975: whole issue.

Thuronyi, Victor. "The Dividend and Interest Exclusion—A Negative Vote." Tax Notes, v. 6, Jan. 7, 1980: 3-7.

Ture, Norman B. and B. Kenneth Sanden. *The Effects of Tax Policy on Capital Formation.* New York: Financial Executives Research Foundation, 1977.

U.S. Congress. Joint Committee on Taxation. *General Explanation of the Economic Recovery Tax Act of 1981,* Dec. 31, 1981: 187-196.

———. Senate. Committee on Finance. *Reform of Corporate Taxation.* Hearing. 98th Cong., 1st sess., Oct. 24, 1983.

von Furstenburg, George M. "Saving," in: Henry J. Aaron and Joseph A. Pechman, eds. *How Taxes Affect Economic Behavior.* Washington, D.C.: The Brookings Institution, 1981: 327-402.

DEDUCTIBILITY OF NON-MORTGAGE INTEREST IN EXCESS OF INVESTMENT INCOME

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	8.8	....	8.8
1987	9.5	....	9.5
1988	10.6	....	10.6
1989	11.6	....	11.6
1990	12.7	....	12.7
1991	13.9	....	13.9

Authorization

Section 163.

Description

A taxpayer may take an itemized deduction for interest paid or accrued on nonbusiness indebtedness (for example, personal and auto loans and credit account purchases) in addition to home mortgages. This interest is deductible even to the extent it exceeds income from investments which the taxpayer holds.

Impact

This provision reduces net interest charges, and thereby reduces the cost of consumer purchases financed by debt. Because higher income taxpayers are more likely to itemize deductions, they are more likely to benefit from this provision than are taxpayers in lower brackets.

Under 1954 legislation, the deduction for carrying charges on most consumer credit (unless explicitly denominated interest) was limited to about 6 percent on the declining balance of consumer debt. In more recent years, bank charge cards have proliferated, and the Internal Revenue Service has ruled that charges on those cards generally can be fully deducted as interest. On the other hand, purchases under deferred payment contracts usually remain subject to the limitation previously mentioned. Thus, the theoretical treatment of bank charge cards differs substantially from deferred payment sales where carrying charges are often not called interest. Whether this distinction is observed in practice is unknown.

Rationale

While the 1862 income tax statute did not contain a special provision for the deduction of interest, it was allowed. When the income tax was reinstituted in 1913, a special provision allowing the deduction of interest was included, apparently because of concern that interest might not be treated as a business expense and deducted under the general business expense provision. At that time, no distinction was drawn between business and nonbusiness interest expense; presumably because the latter constituted a very small proportion of total interest expense. However, today the nonbusiness interest cost is perceived as a consumption item and hence different from business interest.

Further Comment

Many recent proposals for comprehensive tax reform have suggested denying or restricting this deduction. For example, the Treasury tax reform proposal, which would limit the nonmortgage interest deduction to the amount of investment income plus $5,000, identifies the deduction as a major feature of many tax shelter investments. The Treasury proposal also notes that the deduction is allowed with respect to personal expenditures (e.g., for a car or a vacation home) which do not yield offsetting income.

Selected Bibliography

Berry, John M. "Beyond Complaints of the Fearful, Lie Serious Issues of Tax Policy." Financier, v. 9, Apr. 1985: 8-12.

Freeman, Roger A. *Tax Loopholes: The Legend and the Reality.* Washington, D.C.: AEI—Hoover Policy Studies, 1973: 71.

Goode, Richard. *The Individual Income Tax.* Revised edition. Washington, D.C.: The Brookings Institution, 1976: 148-155.

Kahn, C. Harry. *Personal Deductions in the Federal Income Tax.* Princeton, N.J.: Princeton University Press for the National Bureau of Economic Research, 1960: 109-124.

Lavelle, John H. and Glenn E. Davis. "Interest Deduction Has Widespread Application But Restrictions Can Limit Its Effectiveness." Taxation for Accountants, v. 32, May 1984: 280-285.

Lurie, Irene. "A Note on the Inefficiency of Interest Subsidies." National Tax Journal, v. 35, Dec. 1983: 491-496.

U.S. Congress. Joint Committee on Taxation. *General Explanation of the Tax Reform Act of 1976:* 102-104.

(370) Commerce and Housing Credit

FINANCE LEASING

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986		0.1	0.1
1987		.1	.1
1988		.2	.2
1989		.8	.8
1990		1.6	1.6
1991		2.3	2.3

Authorization

Section 168(f)(8).

Description

The law contains rules (true lease rules) to determine who owns an item of property for tax purposes when the property is subject to an agreement which the parties characterize as a lease. The rules are important because it is the owner who is entitled to claim tax benefits for the property, including cost recovery deductions and investment tax credits. The true lease rules attempt to distinguish between true leases, in which the lessor is treated as owning the property for tax purposes, and conditional sales or financing arrangements, in which the user of the property is treated as owning the property for tax purposes. Essentially, the law is that the economic substance of a transaction, not its form, is determinative. Thus, if a transaction, is in substance a financing arrangement, it is treated that way for tax purposes, regardless of how the parties choose to characterize it. Under the true lease rules, lease transactions have to have nontax economic substance: they cannot be used solely for the purpose of transferring tax benefits of ownership from nominal lessees who cannot utilize the benefits to nominal lessors who can.

In the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Congress enacted finance lease rules. For qualifying property, the finance lease rules liberalize the true lease rules in this respect: an agreement which (1) pertains to property that only the lessee can use (limited use property), or (2) contains a fixed price purchase option of 10 percent or more of the lessor's original cost of the property will be treated as a lease for tax purposes—provided that the agreement would be treated as a lease under the true lease rules if these two factors were not taken into account.

Finance lease rules were to have been generally effective for agreements entered into after 1983, with three temporary constraints intended to limit the tax benefits of finance leasing in 1984 and 1985. However, in the Tax Reform Act of 1984, Congress postponed the general effective date to agreements entered into after 1987 and extended the temporary constraints into 1989. Notwithstanding this general postponement, finance lease rules are available prior to 1988 for limited amounts of farm property, certain automotive manufacturing property and cogeneration facilities, and property covered by transitional rules provided in the 1984 Act.

Impact

The finance lease rules lead to more property being leased: first, because the amount of property eligible for leasing is increased by limited use property; and second, because some property users are more willing to lease when a fixed price purchase option is available. The impact on revenue follows from the tax benefits of ownership being claimed sooner by lessors than they would have been claimed by lessees.

Rationale

In the Economic Recovery Tax Act of 1981, Congress enacted the Accelerated Cost Recovery System (ACRS) for determining depreciation deductions in order to lower the tax on income from depreciable property. ACRS deductions and investment tax credits have this effect because they are allowed more rapidly than income is realized from the investment. The effect is less potent, however, for taxpayers who have insufficient taxable income to turn the available deductions and credits into tax savings until some future year. Such taxpayers find that leasing in certain cases gives them greater access to the tax benefits of ownership than would ownership itself. Finance lease rules encourage leasing. Nevertheless, the finance lease rules still respect the standard that leases must have nontax economic substance, whereas the safe harbor lease rules they replaced did not. (Safe harbor leasing, enacted in 1981 and repealed by TEFRA, is described in this Committee's 1982 print on tax expenditures.)

Selected Bibliography

Levine, Howard J. and Ronald S. Cohn. "Equipment Leasing Under TEFRA: New Restrictions and New Opportunities." The Tax Adviser, Nov. 1982: 658–665.

Rolfe, Robert J. and Michael D. DeCelles. "Leveraged Leases After the Tax Reform Act of 1984." The Tax Executive, Jan. 1985: 179–188.

U.S. Congress. Joint Committee on Taxation. *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984.* Joint Committee Print. 98th Cong., 2nd sess., Dec. 31, 1984: 12–18.

———. *General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982.* Joint Committee Print. 97th Cong., 2nd sess., Dec. 31, 1982: 45–67.

Warren, Alvin C., Jr. and Alan J. Auerbach. "Tax Policy and Equipment Leasing After TEFRA." Harvard Law Review, v. 96, May 1983: 1579–1598.

EXCLUSION FOR CERTAIN INCOME FROM DISCHARGE OF INDEBTEDNESS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	(1)	(1)	(1)
1987	(1)	(1)	(1)
1988	(1)	(1)	(1)
1989	(1)	(1)	(1)
1990	(1)	(1)	(1)
1991	(1)	(1)	(1)

[1] Less than $50 million.

Authorization

Sections 108 and 1017.

Description

Under sections 108 and 1017, the amount of indebtedness discharged in a bankruptcy case, or when the debtor is insolvent, is not included in gross income; instead, that amount is applied to reduce certain tax attributes of the debtor (such as net operating losses). In addition, in the case of a solvent taxpayer outside bankruptcy, income realized when indebtedness is cancelled or discharged for less than its full amount (e.g., where a corporation that had issued a $1,000 bond at par later repurchases it for only $900) may be excluded from gross income to the extent that the debtor reduces its basis in depreciable assets. Under a provision enacted in the Tax Reform Act of 1984, the issuance of stock in cancellation of debt by a solvent corporation outside bankruptcy is treated in the same manner as if the corporation had paid money in an amount equal to the fair market value of the stock.

Impact

But for the exclusion provided in sections 108 and 1017, a solvent taxpayer which arranged for cancellation of its indebtedness (outside bankruptcy) at less than the outstanding amount of the loan would recognize ordinary income in the year of the discharge. These provisions postpone recognition of income by permitting an exclusion in the year of discharge for the amount of income from discharge of indebtedness, but only to the extent the taxpayer reduces basis in depreciable assets, and thus reduces the amount of cost recovery deductions otherwise allowable. By virtue of a recapture rule, the character of the gain is unchanged; i.e., any gain on a subsequent sale of the reduced-basis asset is treated as ordinary income. In the case of a debtor in bankruptcy or an insolvent debtor, no income is recognized, but the debtor may not utilize net operating losses, etc. attributable to discharged debt to offset future income.

Rationale

This exclusion, as originally enacted, was intended to allow financially distressed railroads to reorganize their debt structures by retiring their outstanding bonds at a discount, without immediate recognition of gain and payment of tax. This relief was later extended to all corporate debtors, whether or not financially troubled, on the ground that corporations should not be discouraged from retiring their outstanding debt by the prospect of having to pay a tax immediately on the discount. In the case of bankrupt debtors, the exclusion protects the debtor from an immediate tax liability on emerging from bankruptcy, while the required attribute reduction does not permit the debtor to offset subsequent earnings with prebankruptcy tax benefits attributable to indebtedness that will not have to be paid.

Selected Bibliography

Bryan, Patricia. "Cancellation of Indebtedness by Issuing Stock in Exchange: Challenging the Congressional Solution to Debt-Equity Swaps." Texas Law Review, v. 63, Aug. 1984: 89-130

Davenport, Charles. "Tax Strategies and Problems In Times of Financial Distress." Agricultural Law Journal, v. 4, winter 1983: 504-533.

Lawrence, Patricia A. "New Bankruptcy Tax Act Calls for Changes in Planning to Handle Discharges of Indebtedness." Taxation for Accountants, v. 26, Mar. 1981: 154-158.

Noffke, Richard A. "Discharge of Indebtedness Under the Bankruptcy Tax Act of 1980." Taxes, v. 60, Sept. 1982: 635-649.

Phelan, Robin E. and William M. Sharp. "Kick'em While They're Down—A Taxation and Bankruptcy Critique of the Technical and Policy Aspects of the Bankruptcy Tax Act of 1980." Southwestern Law Journal, v. 35, Nov. 1981: 833-878.

U.S. Congress. House. Committee on Ways and Means. *Bankruptcy Tax Act of 1980.* Report on H.R. 5043. 96th Cong., 2d sess., Mar. 19, 1980.

———. *Bankruptcy Tax Act and Minor Tax Bills.* Hearing. 96th Cong., 1st sess., Sept. 29, 1979.

———. Senate. Committee on Finance. *Bankruptcy Tax Act of 1980.* Report on H.R. 5043. 96th Cong., 2d sess., Nov. 25, 1980.

(370) Commerce and Housing Credit

EXPENSING OF $5,000 OF DEPRECIABLE BUSINESS PROPERTY

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	0.1	0.1	0.2
1987	.1	.1	.2
1988	.1	(1)	.1
1989	(1)	(1)	(1)
1990	(1)	−.1	−.1
1991	(1)	−.3	−.3

[1] Less than $50 million.

Authorization

Section 179.

Description

A taxpayer (other than a trust or estate) may elect, in lieu of capital cost recovery deductions, to deduct as an expense up to $5,000 of the cost of qualifying property in the taxable year it is placed in service. The $5,000 ceiling increases to $7,500 for taxable years beginning in 1988 and 1989 and to $10,000 thereafter. In general, qualifying property must be acquired, by purchase, for use in a trade or business and must otherwise be eligible for the investment credit. However, no investment credit is allowed for that portion of the cost of the property expensed under the rule.

Impact

In the absence of this provision, the cost of depreciable business property would have to be recovered over a period of years beginning with the year it is placed in service. The provision therefore permits the depreciation of relatively small amounts of business property to be substantially accelerated.

Rationale

The provision was enacted to assist small businesses and to simplify depreciation accounting for them. The benefits of the provision are not limited to small businesses, however.

Selected Bibliography

Cahlin, Richard A. "Current Deduction Available for Many Costs That Are Capital in Nature." Taxation for Accountants, v. 29, Nov. 1982: 292–295.

Harris, David G. and Ronald C. Maiorano. "Optimizing the Selection Between Full or Reduced Investment Tax Credits and Optional Section 179 Expensing." Tax Adviser, v. 15, Nov. 1984: 686–692.

(370) Commerce and Housing Credit

REINVESTMENT OF DIVIDENDS IN STOCK OF PUBLIC UTILITIES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	0.3		0.3
1987			
1988			
1989			
1990			
1991			

Authorization

Secton 305(e).

Description

Normally, the distribution by a corporation of its own shares of stock to a shareholder where the shareholder has the choice of receiving either stock or other property (including money) is treated as a taxable dividend to the extent of the corporation's earnings and profits.

Under this provision, a shareholder of a public utility may exclude up to $750 ($1,500 in the case of a joint return) of common stock received under a plan giving the shareholder the option to receive his or her distribution as either stock or other property. The provision is in effect through 1985.

Impact

The provision encourages shareholders of public utilities to reinvest their dividends in the public utility rather than withdrawing the funds to use for other purposes.

Rationale

Because property of public utilities is generally recovered over a longer period of time than property of other industries, this provision allows utilities to raise additional capital from shareholders through the reinvestment of dividends and reduces the amount of capital that would be raised from other external sources.

48-178 0 - 86 - 8

Further Comment

This provision was added to the Internal Revenue Code by the Economic Recovery Tax of 1981.

Selected Bibliography

Boyles, Jesse V. and John L. Kramer. "Individuals May Use Dividend Reinvestment to Achieve Significant Tax Savings." Journal of Taxation, v. 57, Aug. 1982: 114-121.

Kiefer, Donald W. *The Impact of the Economic Recovery Tax Act of 1981 on the Public Utility Industry.* Multilith No. 82-6E. Washington, D.C.: The Library of Congress, Congressional Research Service, Jan. 15, 1982: 18-21.

——. *The Tax Exclusion for Dividends Reinvested in Public Utility Stock: Background and Peliminary Evaluation.* Multilith No. 84-613. Washington, D.C.: The Library of Congress, Congressional Research Service, Apr. 30, 1984.

(370) Commerce and Housing Credit

EXPENSING OF MAGAZINE AND NEWSPAPER CIRCULATION EXPENDITURES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	(1)	(1)	(1)
1987	(1)	(1)	(1)
1988	(1)	0.1	0.1
1989	(1)	.1	.1
1990	(1)	.1	.1
1991	(1)	.1	.1

[1] Less than $50 million.

Authorization

Sections 173 and 55–58.

Description

Publishers of newspapers, magazines, and other periodicals generally are permitted to elect to deduct expenditures to establish, maintain or increase circulation in the year that the expenditures are made. Current deductions are permitted under this rule even though certain of the expenditures would otherwise be treated as capital expenditures. Expenditures eligible for current deduction do not include those for the purchase of land or depreciable property or the purchase of any part of the business of another publisher.

For taxable years beginning after 1982, a portion of the circulation expenditures currently deducted under this rule is treated as an item of tax preference subject to the minimum tax. The amount treated as an item of tax preference in any given year is the excess of the amount of circulation expenditures allowable as a deduction under section 173 over the amount which would have been deductible had the circulation expenditures been capitalized and amortized ratably over 3 years. Individual taxpayers may elect to amortize circulation expenditures over 3 years in lieu of currently deducting them, in which case no portion of the amortized circulation expenditures would constitute an item of tax preference.

Impact

Publishers are permitted a current deduction for circulation expenditures, including some expenditures otherwise considered capital in nature. The use of this deduction to shelter other income was somewhat limited when circulation expenditures became subject to the minimum tax; now, current deduction of circulation expenditures may subject income which otherwise would have escaped tax to the minimum tax. If the taxpayer elects to amortize circulation expenditures over a 3-year period to prevent application of minimum tax, there is at least a partial matching of circulation expenditure deductions to related subscription revenue, to the extent subscription income is not deferred beyond the 3-year amortization period.

Rationale

The current deduction rule was codified in 1950 to eliminate the problem of distinguishing between expenditures to maintain circulation (which are currently deductible) and those to establish or develop circulation (which otherwise had to be capitalized).

Selected Bibliography

U.S. Congress. Joint Committee on Taxation. *General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982.* Committee Print. 97th Cong., 2nd sess., Dec. 31, 1984: 16–24.

(370) Commerce and Housing Credit

DEFERRAL OF GAIN ON INSTALLMENT SALES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	(1)	0.2	0.2
1987	(1)	.2	.2
1988	(1)	.2	.2
1989	(1)	.2	.2
1990	(1)	.3	.3
1991	(1)	.3	.3

(1) Less than $50 million.

Authorization

Sections 453, 453A, and 453B.

Description

The installment method for reporting income from dispositions of property permits a deferral of taxation of the income from the disposition over the period the payments are received, rather than taxation in the year of the disposition, except that recapture of previously deducted amounts is taxed in the year of disposition. The taxable portion of each installment payment is that portion which the gross profit on the disposition (adjusted for recapture) bears to the total contract price. The balance of each installment payment is treated as nontaxable return of capital. The installment method is treated as a method of accounting and is mandatory for qualifying sales unless the taxpayer elects not to have it apply. Temporary Treasury regulations provide that, by electing out of the installment method, most taxpayers would generally be taxed in the year the property is disposed of, unless the payments are so contingent that the transaction is treated as "open" and payments are treated as nontaxable return of capital until basis is recovered.

Installment sale treatment applies to casual dispositions of personal property and dispositions of real property where at least one payment is received after the year of disposition. Installment sale treatment is also available, subject to some restrictions, for dealer dispositions of personal property on the installment plan.

If an installment obligation is disposed of, deferral of income taxation is ended and the person disposing of the obligation generally is subject to immediate taxation. An exception to this rule applies to installment obligations distributed in certain types of corporate liquidations.

Impact

Installment sale treatment constitutes a departure from the normal rule that gain is recognized when the sale of property occurs. The deferral of taxation permitted under the installment sale rules essentially furnishes the taxpayer an interest-free loan equal to the amount of tax on the gain that is deferred. The installment sale provisions also cause the buyer and the seller to account for the same transaction at different times. The installment seller generally may defer taxation until he receives payments, whereas the buyer is immediately entitled to include the full amount of the cost of the property in his basis for purpose of his cost recovery deduction, even though he has not made the installment payments.

Rationale

The rationale for permitting installment sale treatment of income from disposition of property is to match the time of payment of tax liability with the cash flow generated by the disposition.

Selected Bibliography

Ginsburg, Martin. "Future Payment Sales After the 1980 Revision Act." Thirty-ninth Annual Institute on Federal Taxation. New York, N.Y.: New York University, 1981: 43-1—43-71.

Guerin, Sanford M. "A Tax Policy Analysis of Wrap-Around Financed Installment Sales." Virginia Tax Review, v. 3, summer 1983: 41-79.

Katz, Robert. "Removal of Several Restrictions to Installment Method Enhance Its Tax Savings Potential." Taxation for Accountants, v. 26, Jan. 1981: 4-8.

U.S. Congress. House. Committee on Ways and Means. *Installment Sales, Subtitle F. Simplification, and Miscellaneous Tax Measures.* Hearing. 96th Cong., 1st sess., July 27, 1979.

———. *Installment Sales Revision Act of 1980.* Report to Accompany H.R. 6883. 98th Cong., 2d sess., Report No. 96-1042.

———. *Installment Sales Revision Act of 1980 and Minor Tax Bills.* Hearing. 96th Cong., 2d sess., Apr. 17, 1980.

Senate. Committee on Finance. *Installment Sales Revision Act of 1980.* Report to Accompany H.R. 6883. 96th Cong., 2d sess., Report No. 96-1000.

COMPLETED-CONTRACT METHOD OF ACCOUNTING

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	0.4	4.3	4.7
1987	.4	4.4	4.8
1988	.4	4.8	5.2
1989	.4	5.1	5.5
1990	.5	5.3	5.8
1991	.5	5.5	6.0

Authorization

Public Law 97-248, section 229, and regulations under section 451.

Description

A taxpayer using the completed-contract method of accounting reports income on long-term contracts on a transactional basis. Thus, income on a particular contract is not reported until the contract has been completed. Likewise, the deduction of all costs properly allocable to the contract is postponed until the contract is completed. However, indirect costs not incident to and necessary for the performance of long-term contracts may be deducted in the year paid or incurred.

Impact

The tax code generally requires that income be reported on an annual accounting basis rather than on a transactional basis. The completed-contract method permits recognition of income to be postponed until a taxable year after it would be under other methods of accounting, and thus permits deferral of tax.

Rationale

The completed-contract method is intended to match, at the end of the contract, the income from long-term contracts with the expenses incurred in performing those contracts. If deferral of income until contract completion were not allowed, a taxpayer could be required to report income as it completed the contract even though, viewed on a transactional basis, the contract produces a net loss (total costs incurred in connection with the contract exceed total receipts).

Selected Bibliography

Harris, Goldston, Donald Flannery and Joseph Jordan. "Contractors' Leeway to Defer Tax Liability Restricted by TEFRA Provisions." Journal of Taxation, v. 57, Dec. 1982: 344–348.

U.S. Congress. Joint Committee on Taxation. *General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982.* Committee Print. 97th Cong., 2nd sess., Dec. 31, 1984: 148–156.

(370) Commerce and Housing Credit

EXPENSING COSTS OF REMOVING ARCHITECTURAL BARRIERS TO THE HANDICAPPED AND ELDERLY

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	(1)	(1)	(1)
1987	(1)	(1)	(1)
1988			
1989			
1990			
1991			

[1] Less than $50 million.

Authorization

Section 190.

Description

The Tax Reform Act of 1984 reinstated Code section 190, providing a special tax deduction for expenses incurred in removing architectural or transportation barriers to the handicapped and the elderly, for taxable years beginning after 1983 and before 1986. (The provision had expired for years beginning after 1982.) The maximum deduction allowed to a taxpayer for any taxable year was increased to $35,000 by the 1984 Act.

Section 190 applies to expenses incurred to make facilities, or transportation vehicles owned or leased by the taxpayer for use in the taxpayer's trade or business, more accessible to, and usable by, the handicapped and elderly. To be entitled to the deduction, the taxpayer must establish that the barrier removal meets standards set by the Treasury with the concurrence of the Architectural and Transportation Barriers Compliance Board. Under section 190, the definition of an elderly person is a person age 65 or over, and handicapped individuals include the blind and the deaf.

Impact

The provision lessens the after-tax cost of removing architectural barriers to the handicapped by accelerating the deduction for such expenses, subject to the $35,000 cap per year.

Rationale

The Congress believed that it was desirable to encourage the removal of architectural and transportation barriers to the handicapped and the elderly through reinstating the deduction for certain expenses incurred in the removal of such barriers, and increasing the maximum annual deduction to $35,000.

Selected Bibliography

U.S. Congress. Joint Committee on Taxation. *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984.* Committee Print. 98th Cong., 2d sess., Dec. 31, 1984: 1176–1177.

CASH METHOD OF ACCOUNTING, OTHER THAN AGRICULTURE

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	(1)	0.1	0.1
1987	(1)	.1	.1
1988	(1)	.1	.1
1989	(1)	.1	.1
1990	(1)	.1	.1
1991	(1)	.1	.1

[1] Less than $50 million.

Authorization

Section 446.

Description

The Internal Revenue Code provides for the following permissible methods of accounting: (1) the cash receipts and disbursements method, (2) an accrual method, or (3) any other method or combination of methods permitted under Treasury regulations. A taxpayer is entitled to adopt any one of the permissible methods for each separate trade or business of the taxpayer, provided that the method selected clearly reflects the taxpayer's income from such trade or business. A method of accounting that reflects the consistent application of generally accepted accounting principles ordinarily is considered to reflect income clearly. Except as discussed below, the cash method is generally available to most taxpayers.

The cash method of accounting generally requires an item to be included in income when actually or constructively received and permits a deduction for an expense when paid. In contrast, the principles of the accrual method of accounting generally require that an item be included in income when all the events have occurred that fix the right to its receipt and its amount can be determined with reasonable accuracy. Similarly, a deduction is allowed to an accrual-basis taxpayer when all events have occurred that determine the fact of liability for payment, the amount of the liability can be determined with reasonable accuracy, and the economic performance that establishes the liability has occurred.

In general, taxpayers (other than farmers) for whom the production, purchase, or sale of merchandise is an income-producing factor in a particular trade or business, must take into account merchandise on hand (including finished goods, work-in-process, new materials and supplies) at the beginning and end of the year into account in computing taxable income for the year. This process is known as using "inventories." Any other permissible method of accounting (including the cash method) may be used for other purposes in that trade or business or for other trades or businesses of the taxpayer so long as the method clearly reflects income.

Special rules apply to the use of the cash method of accounting for agricultural activity.

Impact

The cash method of accounting frequently fails to reflect the economic results of a taxpayer's business over a taxable year. The cash method reflects actual cash receipts and disbursements, which need not be related to economic income. Obligations to pay and rights to receive payment are disregarded under the cash method, even though they directly bear on whether the business has generated an economic profit or a loss. Consequently, use of the cash method may result in the mismatching of income and expense and in the deferral of income tax. Because of its inadequacies, the cash method of accounting is not considered to be in accord with generally accepted accounting principles and, therefore, is not permissible for financial accounting purposes. Current law, however, permits many taxpayers that already use an accrual method for financial accounting purposes to use the cash method for income tax purposes.

The cash method also produces a mismatching of income and deductions where the taxpayer engages in transactions with parties that employ a different method of accounting. For example, an accrual-method taxpayer may deduct certain liabilities as incurred, such as liabilities for certain services rendered, even though the service provider on the cash method may defer reporting income until cash payment is made.

Rationale

The relative simplicity of the cash method makes its use more appropriate for tax purposes for smaller, less sophisticated taxpayers, for whom accrual accounting may be burdensome.

Selected Bibliography

Ferencz, Robert. "A Review of Tax Planning Techniques for Mismatching Income and Expenses." Taxes, v. 61, Dec. 1984: 829–843.

Landey, Kate M. "Payments of Expenses by Credit Card: A Current Deduction for the Cash-Method Taxpayer?" Taxes, v. 62, Apr. 1984: 239–246.

Pizzica, Judith Helm. "Opportunities Exist for a Cash-Basis Taxpayer to Defer the Reporting of Income." Taxation for Accountants, v. 29, July 1982: 4–7.

(370) Commerce and Housing Credit

RESERVE METHOD FOR BAD DEBT DEDUCTIONS, OTHER THAN FINANCIAL INSTITUTIONS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	(1)	NA	NA
1987	(1)	0.5	0.5
1988	(1)	.5	.5
1989	(1)	.6	.6
1990	(1)	.6	.6
1991	(1)	.6	.6

[1] Less than $50 million.

Authorization

Section 166.

Description

Taxpayers other than depository institutions may deduct a business bad debt in the year in which it becomes wholly or partially worthless. Instead of deducting specific bad debts, a taxpayer may take a deduction for additions to a bad debt reserve for the obligations created or acquired in the course of a trade or business and held by the taxpayer at the close of the taxable year. In any year, the amount of such additions that may be deducted is an amount sufficient to bring the reserve to a reasonable level. The purpose of the reserve is to estimate the portion of the obligations held by the taxpayer at year-end that will become uncollectible in the future. Debts that become worthless during the year are charged against the reserve. This charge reduces the reserve and hence increases the amount that may be added to the reserve to restore it to a reasonable level.

Many taxpayers use the so-called "Black Motor" formula to compute a reasonable addition to the bad debt reserve. Under this formula, a taxpayer computes the ratio of the taxpayer's total bad debts to total accounts receivable in the preceding 6 years, and applies this ratio to the total receivables at the end of the year. The amount of bad debts charged to the reserve during the year is then added to the amount just arrived at, and the amount of bad debts recovered during the year is then substracted. The reasonable addition is the difference between this amount, known as the "total reserve requirement," and the balance in the reserve at the end of the prior taxable year.

A dealer in property may deduct a reasonable addition to a reserve for bad debts relating to its liability as a guarantor of debt obligations arising out of the sale by the taxpayer or property in the ordinary course of its trade or business.

Other special rules govern the deduction for addition to reserves for bad debts of depository institutions.

Impact

The reserve method for bad debt deductions of nonfinancial businesses allows taxpayers a deduction for estimated future loan losses without any discount for the present value of such losses. The deduction for additions to a bad debt reserve effectively allows debts that become worthless during the year as well as future bad debts (attributable to the increase in the amount of receivables held at year-end) to be deducted in the taxable year, particularly if the "Black Motor" formula is used. The undiscounted deduction for future losses may result in overstatement of the economic loss from bad debts, and therefore, understatement of the taxpayer's income.

Selected Bibliography

Birrell, Terry. "The ABC's of Bad Debt Losses." Practical Accountant, v. 17, July 1984: 23, 24, 26, 28, 30–34.

Iannacone, William and Mitchell K. Dario. "Advance Planning for Receivables Can Maximize Efficient Use of a Reserve for Bad Debts." Taxation for Accountants, v. 30, Feb. 1983: 76–81.

(370) Commerce and Housing Credit

AMORTIZATION OF TRADEMARK EXPENSES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	(1)	(1)	(1)
1987	(1)	(1)	(1)
1988	(1)	(1)	(1)
1989	(1)	0.1	0.1
1990	(1)	.1	.1
1991	(1)	.1	.1

[1] Less than $50 million.

Authorization

Section 177.

Description

Current law permits taxpayers to elect to amortize over a period of at least 60 months any expenditure paid or incurred in the taxable year for the acquisition, protection, expansion, registration, or defense of a trademark or trade name, other than an expenditure which is part of the consideration for an existing trademark or trade name. A separate election may be made by the taxpayer with respect to each separate trademark or trade name expenditure.

Impact

A trademark or trade name distinguishes a firm and/or its products from other firms and/or their products. The costs of acquiring trademarks are capital outlays for an intangible asset, similar to expenditures to organize a business. Although a trademark or trade name may prove to be unprofitable, or even worthless, it is not otherwise a wasting asset whose value is expected to decrease over time. To the contrary, the ordinary investor acquiring a trademark or trade name expects the value of the asset to appreciate along with the development of the products that it represents. Consequently, permitting capital cost recovery for such investments results in acceleration of deductions and deferral of income tax.

Rationale

When section 177 was enacted in 1956, the accompanying legislative history indicated that Congress intended to equate the treatment of taxpayers acquiring trademarks using in-house legal services with the treatment of taxpayers using outside legal counsel. At the time, the cost of services provided by in-house lawyers was currently deducted, while the cost of services provided by outside counsel was capitalized. H.R. Rep. No. 1607, 84th Cong. 1st Sess. (July 30, 1955), 1956-2 C.B. 1226, 1232-1233. Under present law, however, the cost of in-house legal services must be capitalized. *See Commissioner* v. *Idaho Power Co.,* 418 U.S. 1 (1974).

Selected Bibliography

Petry, Marvin. "Tax Treatment of Trademark Infringement Litigation Expenditures (and Recommendations for Change)." Trademark Reporter, v. 73, Jan.-Feb. 1983: 52-63.

(400) Transportation

DEFERRAL OF TAX ON SHIPPING COMPANIES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986		0.2	0.2
1987		.1	.1
1988		.1	.1
1989		.1	.1
1990		.1	.1
1991		(1)	(1)

[1] Less than $50 million.

Authorization

46 U.S.C. section 1177 (sec. 607 of the Merchant Marine Act of 1936, as amended), section 46(g) of the Internal Revenue Code, and court decisions.

Description

U.S. operators of vessels in foreign, Great Lakes, or noncontiguous domestic trade or in U.S. fisheries may establish a capital construction fund (CCF) in which they may make certain deposits. Such deposits are deductible from taxable income, and income tax on the earnings of the deposits in the CCF is deferred.

When tax-deferred deposits and their earnings are withdrawn from a CCF, no tax is paid if the withdrawal is used for qualifying purposes, such as to construct or acquire a new vessel or to pay off indebtedness of a qualifying vessel. The tax basis of the vessel (usually its cost to the taxpayer), with respect to which the operator's depreciation deductions are computed, is reduced by the amount of such withdrawal. Thus, over the life of the vessel, tax depreciation will be reduced and taxable income will be increased by the amount of such withdrawal, thereby reversing the effect of the deposit. However, since gain on the sale of the vessel and income from the operation of the replacement vessel may be deposited into the CCF, the tax deferral may be extended indefinitely.

An investment tax credit of at least one-half the regular credit is specifically allowed for tax-deferred amounts withdrawn from CCF's that are used to purchase, construct, or reconstruct qualified vessels. The U.S. Court of Claims (now the Claims Court) has allowed a full investment credit in such instances. See, e.g., *Pacific*

Far East Line, Inc. v. *U.S.* 76-2 USTC para. 9718 (1976). Withdrawals for purposes other than for construction, acquisition, or payment on indebtedness of a qualifying vessel are taxed at the time of withdrawal.

Rationale

The provision is designed to stimulate American shipbuilding and to recapture some of the foreign yard construction now being done for U.S. companies.

Although tax subsidies of various types have been in existence since 1936, the coverage of the subsidies was expanded substantially by the Merchant Marine Act of 1970.

Prior to the Tax Reform Act of 1976, it was unclear whether any investment tax credit was available for eligible vessels financed in whole or in part out of funds withdrawn from a CCF. The 1976 Act specifically provided that a minimum investment credit equal to 50 percent of an amount withdrawn which was to purchase, construct, or reconstruct qualified vessels was available in 1976 and subsequent years.

Selected Bibliography

Jantscher, Gerald R. *Bread Upon The Waters: Federal Aids to the Maritime Industries.* Chapter VI—"Tax Subsidies to the Maritime Industries." Washington, D.C.: The Brookings Institution, 1975.

Madigan, Richard E. *Taxation of the Shipping Industry.* 2nd ed. Cornell Maritime Press, Centreville, Md., 1982.

U.S. Congress. House. Committee on Ways and Means. *Eligibility of Maritime Capital Construction Fund Withdrawals for Investment Tax Credit.* Hearing. 94th Cong., 1st sess., Dec. 15, 1975.

———. Joint Committee on Taxation. *General Explanation of the Tax Reform Act of 1976.* Dec. 29, 1976: 186-188.

EXCLUSION OF INTEREST ON STATE AND LOCAL GOVERNMENT IDB's FOR MASS TRANSIT

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	0.1	(2)	0.1
1987	.1	(2)	.1
1988	(1)	(2)	(1)
1989	(1)	(2)	(1)
1990	(1)	(2)	(1)
1991	(1)	(2)	(1)

[1] Less than $50 million.
[2] Less than −$50 million.

Authorization

Sections 103(b)(4) (D) and (I), (b)(9), and (n), and 168(f)(8)(D)(v) of the Internal Revenue Code.

Description

Bonds to finance terminals and other mass transit commuting facilities have been exempt from tax under a Code provision enacted in 1968.

The Economic Recovery Tax Act of 1981 (ERTA) provided that interest on obligations of a State or local government is exempt from Federal income tax if substantially all of the proceeds of the obligations are used to provide qualified mass commuting vehicles. The act defined such vehicles to mean any bus, subway car, rail car, or similar equipment that is leased to a mass transit system that is wholly owned by one or more governmental units—or agencies or instrumentalities of such units—and that is principally used by the mass transit system in providing mass commuting services to the general public.

These ERTA amendments to the Code enabled governmental units and lessors to share the tax benefits of tax-exempt bond financing and ACRS. As a result, governmental units may receive the benefits of accelerated depreciation—under ACRS—through reduced lease payments, and lessors may benefit from the lower tax-exempt interest rates which ordinarily would not be allowed to lessors as the ostensible owners of the vehicles.

The allowance of safe-harbor leasing is limited to mass commuting vehicles placed in service before 1988, and tax-exempt bonds could be issued for leased mass transit vehicles through December 31, 1984.

Under the Deficit Reduction Act of 1984, IDB's for mass transit are subject to the overall volume limitation for private activity tax-exempt bonds. The amount of all such bonds that may be issued by a State during any given year is equal to the greater of (1) the product of $150 times the number of residents of the State, or (2) $200 million.

Impact

State and local governments or their transit authorities were able to share in the cost-reducing benefits of the accelerated cost recovery system through the sale and leaseback provisions of the 1981 Act.

Rationale

The prospect of reductions in Federal grants for mass transit systems stimulated a search for alternative, beneficial, tax provisions. The IDB and leasing amendments in ERTA were required before tax-exempt interest and accelerated recovery of equipment costs could be used advantageously by State and local governments.

Selected Bibliography

Bullock, Alice G. "Is There Life After Safe Harbor Leasing?" New England Law Review, v. 19, No. 1, 1983-84: 1-17.

Lamb, Robert and Robert Knighton. *Leveraged Leasing of Mass Community Vehicles: A Guide for the Transit Operator.* Albany, N.Y.: New York State Department of Transportation, 1982: 21p.

"Safe Harbor Mass Community Vehicle Lease," in: *A Guide to Municipal Leasing,* A. John Vogt and Lisa Cole, eds. Municipal Finance Offices Association, 1983: 22-25.

U.S. Congress. Joint Committee on Taxation. *Analysis of Safe-Harbor Leasing.* Joint Committee Print. 97th Cong., June 1982: 29-31.

FIVE-YEAR AMORTIZATION FOR HOUSING REHABILITATION

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	(1)	(1)	(1)
1987	(1)	(1)	(1)
1988	(1)	(1)	(1)
1989	(1)	(1)	(1)
1990	(1)	(1)	(1)
1991	(1)	(1)	(1)

[1] Less than $50 million.

Authorization

Section 167(k).

Description

In lieu of capital cost recovery, certain expenditures incurred to rehabilitate low- or moderate-income rental housing may be amortized over 5 years using the straight-line method and no salvage value. This rapid amortization is permitted only for expenditures of $20,000 or less per rental unit ($40,000 per unit for rehabilitation conducted pursuant to a program under which tenants may purchase their units at a price that limits the profit to the seller). The amortization is available only where, during a period of 2 consecutive years, expenditures exceed $3,000 per unit. The use of 5-year amortization, instead of the 15-year recovery normally allowed, benefits the taxpayer by effectively deferring current tax liability.

Impact

The tax benefits accrue to investors in projects to rehabilitate low- and moderate-income housing. Even through the properties in question may not be currently earning income, the rapid amortization may be deducted against other income and thus may provide a tax shelter for totally unrelated income. Low-income renters benefit only to the extent that rehabilitated units rent for less than new units of comparable quality, or to the extent that more units are rehabilitated than would be otherwise. The very small amount of evidence available does not indicate a flowthrough of tax benefits to the renters.

Rationale

This provision was adopted as part of the Tax Reform Act of 1969 as a temporary provision to stimulate rehabilitation of low- and moderate-income housing. It was subsequently extended for 1 year by Public Law 93-625 (Jan. 3, 1975). Although it expired December 31, 1975, a retrocative reinstatement through 1977 was added in the Tax Reform Act of 1976, which slighty liberalized the provision as well. The provision was extended again in November 1977 on a temporary basis through the end of 1978 and extended again in 1980 through the end of 1983. The higher limit of $40,000 per unit on certain rehabilitations was enacted in 1981. Although the provision expired on January 1, 1984, a retroactive reinstatement through 1986 was added by the Tax Reform Act of 1984.

Selected Bibliography

Bruesseman, William B., Jeffrey D. Fisher and Jerrold J. Stern. "Rental Housing and The Economic Recovery Tax Act of 1981." Public Finance Quarterly, v. 10, Apr. 1982: 222-241.

Center for Urban Policy Research, ed. *Housing: Economic, Social and Policy Perspectives.* New Brunswick, N.J. 1983.

Hoeflich, Michael H. and James Snedden. "Financing Strategies for Residential Rental Real Estate Under the Economic Recovery Tax Act of 1981." Tax Adviser, v. 13, May 1982: 282-288.

Spragens, Janet R. "The Rehabilitation of Low-Income Rental Housing: A Look at the Section 167(k) Program and the Direct Subsidy Alternative." Case Western Law Review, v. 28, spring 1978: 682-709.

U.S. Congress. Joint Committee on Taxation. *General Explanation of the Economic Recovery Tax Act of 1981.* Committee Print. 97th Cong., 1st sess., Dec. 29, 1981: 178.

U.S. General Accounting Office. *Federal Rental Housing Production Incentives: Effect on Rents and Investor Returns.* Report No. GAO/RCED-85-114, May 10, 1985.

———. *Impact of Federal Tax Provisions on Resyndication of Federally Assisted Rental Housing.* Report No. GAO/RCED-85-112, July 16, 1985.

INVESTMENT CREDIT FOR REHABILITATION OF STRUCTURES OTHER THAN HISTORIC STRUCTURES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	0.2	0.2	0.4
1987	.2	.2	.4
1988	.2	.2	.4
1989	.2	.3	.5
1990	.3	.3	.6
1991	.3	.3	.6

Authorization

Section 48(g).

Description

Amounts spent on substantial rehabilitations of nonresidential buildings over 40 years old qualify for a tax credit of 20 percent and on nonresidential buildings over 30 years old for a credit of 15 percent. In order to qualify for the credit, at least 75 percent of the exterior walls must be retained as external walls after the rehabilitation, and the amount spent on the rehabilitation must exceed the greater of $5,000 or the initial adjusted basis of the building. An alternative to the 75-percent-of-external-walls test requires that at least 50 percent of the building's external walls be retained in place as external walls, at least 75 percent of the external walls be retained as external or internal walls, and at least 75 percent of the internal framework be retained in place. Amounts recovered through these tax credits cannot be deducted through capital cost recovery, that is, there must be a basis adjustment. For instance, an owner who takes the 20 percent credit for $100,000 spent on rehabilitating a 50-year old factory can only recover the remaining $80,000 ($100,000 minus $20,000). In addition, owners are resticted to a straightline recovery method for rehabilitation expenditures, and part of the credit is recaptured if the property is sold within the first 5 years. These credits effectively allow taxpayers to defer tax liability and erase some tax liability.

Impact

These provisions encourage business to renovate rather than relocate. They reduce the cost of rehabilitation and therefore can turn unprofitable rehabilitation into profitable rehabilitation and make rehabilitation more profitable than new construction.

Rationale

The 15- and 20-percent credits were enacted in 1981 and replaced a 10-percent credit that had been available since 1978 for rehabilitations of nonresidential buildings over 20 years old. The Congress enacted the larger credits at the same time that it significantly shortened recovery periods in general, because it wanted to counteract any tendency on the part of the general provisons to encourage firms to relocate and build new plants. Relocation can cause hardship to the families of workers and communities left behind that the firm would not take into account in its decision.

Selected Bibliography

Davis, Glenn E. and Roxanne J. Coady. "Tax Incentives for Rehabilitating Real Estate Increased by New Law." Taxation for Accountants, v. 27, Nov. 1981: 290–294.

Gaines, James P. and Edward J. Schnee. "New Tax Incentives for Rehabilitated Real Estate Investment." Real Estate Issues, fall/winter 1980: 25–28.

Gensheimer, Cynthia F. "Rehabilitation Tax Credits Enacted in the Economic Recovery Tax Act of 1981." Journal of Real Estate Taxation, v. 9, summer 1982: 299–318.

Fisher, Jeffrey D., George H. Lentz and Jerrold J. Stern. "Tax Incentives for Investment in Nonresidential Real Estate." National Tax Journal, v. 37, Mar. 1984: 69–87.

U.S. Congress. Joint Committee on Taxation. *General Explanation of the Revenue Act of 1978,* Mar. 12, 1979: 155–158.

———. *General Explanation of the Economic Recovery Tax Act of 1981,* Dec. 31, 1981: 111–116.

EXCLUSION OF INTEREST ON STATE AND LOCAL GOVERNMENT IDB's FOR AIRPORTS AND OTHER LARGE-SCALE PUBLIC FACILITIES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	NA	NA	NA
1987	1.0	−0.1	0.9
1988	1.1	−.1	1.0
1989	1.3	−.1	1.2
1990	1.4	−.1	1.3
1991	1.6	−.1	1.5

Authorization

Section 103(b) of the Internal Revenue Code of 1954, as most recently amended by Public Law 98–369 (Deficit Reduction Act of 1984).

Description

The interest on bonds issued by State and local governments to finance convention or trade show facilities or airports, docks, wharves, mass commuting facilities (e.g., terminals), or parking facilities is exempt from tax, subject to the restrictions and limitations applicable to industrial development bonds (IDB's) generally. (For further details, see the section in function 370 on the Exclusion of Interest on State and Local Industrial Development Bonds.) Bonds to finance these types of facilities are exempt from the volume limitations for private activity bonds contained in the Deficit Reduction Act of 1984, provided that such facilities are owned for tax purposes by (or on behalf of) a State or local government. (Parking facilities qualify for this exemption only when functionally related and subordinate to another qualifying facility, e.g., airport parking facilities.) Bonds for privately owned facilities are subject to the volume limitation.

Impact

State and local governments may reduce the construction costs of airports and other large-scale facilities by issuing tax-exempt bonds. If the facilities are owned by a governmental unit, this may be accomplished without reducing a State's ability to issue IDB's for other chosen purposes.

Rationale

When Congress placed limits on industrial development bonds in 1968, it continued to allow bonds for airports, etc. on the grounds that such facilities served an important public function. The exemption of such facilities from the IDB volume cap in 1984 was based on a similar judgment. Additionally, it was argued that including such bonds would allow single, large-scale projects to take up all or most of some States' volume cap.

Further Comments

The availability of tax-exempt bonds to finance large-scale facilities may tend to encourage construction of such facilities at the expense of other types of projects, particularly given the exemption from the 1984 volume caps. It may also be difficult to distinguish between public and private benefits in these cases (e.g., where an airport is publicly owned but is utilized primarily by one or two major airlines).

Selected Bibliography

Advisory Committee on Intergovernmental Relations. *Strengthening the Federal Revenue System. Implications for State and Local Taxing and Borrowing.* A Commission Report (H-97). Washington, D.C., 1985: 115-132.

Eizen, Bernard and Csik, Debra. *Industrial Development Bonds: The Import of the Deficit Reduction Act of 1984.* Tax Adviser, January 1985: 2-12.

(500) Education, Training, Employment, and Social Services

EXCLUSION OF SCHOLARSHIP AND FELLOWSHIP INCOME

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	0.6		0.6
1987	.9		.9
1988	.9		.9
1989	1.0		1.0
1990	1.1		1.1
1991	1.1		1.1

Authorization

Section 117.

Description

Generally, individuals may exclude from taxable income amounts received as scholarships or fellowships. The exclusion includes amounts received to cover such incidental expenses as travel, research, clerical assistance, or equipment, but does not apply to any amount received as payment for teaching, research, or similar services. The amount that degree candidates may exclude is unlimited. Scholarships and fellowships for nondegree candidates may be excluded only if the grantors meet certain requirements; further, the amount that they may exclude is limited.

Impact

The value of the tax benefit received by each recipient of a tax-exempt scholarship or fellowship grant is small in many cases because grants are of modest amounts and the recipients have little or no tax liability.

Rationale

Prior to the Internal Revenue Code of 1954, scholarships were included in income unless the taxpayer could show that the grant was a gift. This treatment was considered to lack uniformity. The ostensible purpose of the exclusion was to make treatment of taxpayers consistent and uniform. The only amendment to this section, made in 1961 (Public Law 87-256), expanded the category of qualifying grantors of nondegree candidates' scholarships and fellowship grants.

Selected Bibliography

Ferrell, William R. "Cancelled Student Loans: Scholarships or Taxable Income." Journal of Student Financial Aid, v. 8, Mar. 1978: 17-21.

Mylan, John J. "Current Tax Treatment of Educational Costs." University of Florida, v. 32, spring, 1980: 387-423.

Sanders, Michael I. "Tax Aspects of Scholarship Programs." The Practical Lawyer, v. 26, October 15, 1980: 81-87.

Savage, Allan H. "The Taxation of Scholarships and Fellowships: Continuing Controversy and Confusion." Tax Adviser, v. 15, Jan. 1984: 41-47.

Tipgos, Manuel A. "The Taxability of Scholarships and Fellowships Revisited." Taxes, v. 57, Aug. 1979: 538-546.

U.S. Congress. Congressional Budget Office. *Federal Aid to Post-Secondary Students: Tax Allowances and Alternative Subsidies,* 1978.

———. House. *Internal Revenue Code of 1954.* H. Report No. 1337, 83d Cong., 2d sess., 1954: 17-18, 188-190.

———. Joint Committee on Taxation. *General Explanation of the Revenue Act of 1978,* Mar. 12, 1979: 118-121.

(500) Education, Training, Employment, and Social Services

EXCLUSION OF INTEREST ON STATE AND LOCAL STUDENT LOAN BONDS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	0.2	0.1	0.3
1987	.3	.1	.4
1988	.3	.1	.4
1989	.3	.1	.4
1990	.3	.1	.4
1991	.3	.1	.4

Authorization

Section 103(a) of the Internal Revenue Code of 1954.

Description

State and local agencies can issue bonds and use the proceeds to make or purchase student loans. Nearly all of the student loans so financed are guaranteed student loans (GSL's), on which the Federal Government pays a share of the interest and the student pays the remainder. The student loans backing these bonds are guaranteed by State agencies which are reimbursed by the Federal Government for defaulted loans.

The special allowance payments made by the Federal Government are not included in the yield of the loans for purposes of determining whether the bonds violate the arbitrage rules governing all tax-exempt bonds. These rules generally limit the yield on the loans to no more than 1.5 percentage points above the yield on the bonds, to prevent issuers from profiting from tax-exempt bonds. Because the issuers of student loan bonds can raise funds at a lower cost than banks can, loans financed with the proceeds of tax-exempt bonds earn only half the special allowance other loans do (chiefly those financed by banks).

Tax-exempt bonds have also financed parent loans and loans to medical and dental students.

Under the Deficit Reduction Act of 1984, IDB's for student loans are subject to the overall volume limitation for private activity tax-exempt bonds. The amount of all such bonds which may be issued in a State during any given year is equal to the greater of (1) $150 for each resident of the State, or (2) $200 million. In addition to volume limitations, the 1984 Act specifically restricts tax-exempt financing to bonds issued under the Federal GSL and PLUS programs, except for certain specifically identified State programs which may continue to issue non-GSL bonds. The act also requires a study of new arbitrage rules for student loan bonds and clarifies that State and local governments may issue taxable student loan bonds without prejudice to their future ability to issue tax-exempt obligations.

Proposed Department of Education regulations would impose even more stringent limitations on student loan bonds, including a requirement that taxable sources of financing be exhausted before tax-exempt bonds are issued.

Impact

Student loan bonds may increase somewhat the availability of student loans, but they do not lower the interest rate to students since this is set by Federal law. They create a secondary market for student loans in much the same way the Student Loan Marketing Association does.

The bonds first came into widespread use in the early 1970's. By 1983, student loan bonds had been issued in 26 States and the District of Columbia. A total of $3.1 billion of these bonds was issued in 1983.

Rationale

State and local governments are permitted to issue tax-exempt student loan bonds as part of their general authority to issue tax-exempt bonds. Authority for local nonprofit corporations to issue such bonds was granted in the Tax Reform Act of 1976.

Further Comment

The 1984 tax law changes suggest a congressional policy of limiting tax-exempt student loan bonds.

Selected Bibliography

Neubig, Tom. "The Needless Furor Over Tax-Exempt Student Loan Bonds." Tax Notes, Apr. 2, 1984: 93–96.

U.S. Congress. Congressional Budget Office. *State Profits on Tax-Exempt Student Loan Bonds: Analyses and Options,* 1980.

———. House. *Higher Education Extension and Revision.* H. Report 96–1337, 96th Cong., 2d sess., 1980: 63–65.

EXCLUSION OF INTEREST ON STATE AND LOCAL BONDS FOR PRIVATE EDUCATIONAL INSTITUTIONS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	0.3	(1)	0.3
1987	.3	(1)	.3
1988	.3	(1)	.3
1989	.4	(1)	.4
1990	.4	(1)	.4
1991	.5	(1)	.5

[1] Less than $50 million.

Authorization

Sections 103 (a) and (b) of the Internal Revenue Code of 1954 and Revenue Ruling 63020.

Description

The interest on bonds issued by State and local governments to finance benefits for private educational institutions (e.g., universities) may be excluded from gross income regardless of issue size.

Bonds to finance public educational institutions are similarly exempt from tax as general State and local debt (see function 850). Because the beneficiary institutions are tax-exempt, the bonds are not subject to the volume limitation or other Internal Revenue Code rules regarding industrial development bonds.

Impact

Tax-exempt bonds subsidize the cost of construction and other projects for educational institutions. Because the interest is tax exempt, the issuer can offer bonds at lower interest rates than an institution would pay if it issued bonds. Reported bond sales to benefit private educational institutions in 1983 were $2.1 billion, accounting for approximately 2.3 percent of all new long-term tax-exempt debt.

Rationale

The use of tax-exempt bonds for private educational institutions is part of a general policy of allowing tax-exempt bonds to finance private activities which are themselves tax-exempt. This policy, in turn, may be justified on the grounds of the public purpose which is served by private exempt institutions (schools, charities, etc.). Tax-exempt bonds may be issued for construction or other activities related to the tax-exempt purpose of the qualifying institution.

Further Comment

As in the case of other tax-exempt bonds, direct subsidies for educational institutions may be a less expensive and more efficient alternative than tax-exempt financing, since the entire subsidy would go to the institution; with tax-exempt bond financing, as much as a third of the subsidy goes to bondholders, underwriters, and bond counsel. However, with recent reduction in direct aid programs, tax-exempt bonds may prove even more attractive to private institutions.

Selected Bibliography

Ott, David J. and Allan H. Meltzer. *Federal Tax Treatment of State and Local Securities.* Washington, D.C.: The Brookings Institution, 1963.

(500) Education, Training, Employment, and Social Services

TARGETED JOBS CREDIT

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	0.1	0.2	0.3
1987	(1)	.1	.1
1988	(1)	.1	.1
1989	(1)	(1)	(1)
1990	(1)	(1)	(1)
1991	(1)	(1)	(1)

[1] Less than $50 million.

Authorization

Sections 51 and 52.

Description

This provision provides a nonrefundable tax credit to employers who hire new employees from nine targeted groups. The targeted groups are (1) vocational rehabilitation referrals; (2) economically disadvantaged youth (ages 18–24); (3) economically disadvantaged Vietnam-era veterans; (4) SSI recipients; (5) general assistance recipients; (6) economically disadvantaged cooperative education students (ages 16–19); (7) economically disadvantaged former convicts; (8) economically disadvantaged summer youth employees (aged 16–17); and (9) AFDC recipients and WIN registrants.

The credit generally is equal to 50 percent of the first $6,000 of qualified first-year wages plus 25 percent of the first $6,000 of qualified second-year wages paid to a member of a targeted group. With respect to economically disadvantaged summer youth employees, however, the credit is equal to 85 percent of up to $3,000 of wages.

As initially enacted, the targeted jobs credit was intended to be available for qualified wages paid before 1982. The credit was successively extended by the Economic Recovery Tax Act of 1981, the Tax Equity and Fiscal Responsibility Act of 1982, and the Deficit Reduction Act of 1984: it is presently available for qualified wages paid to individuals who begin work for the employer before 1986. The 1981, 1982, and 1984 Acts also altered the targeted group definitions and made a number of technical and administrative changes in the credit provisions.

Impact

Since no more than $6,000 of wages during either the first or second year of employment may be taken into account with respect to any individual, the maximum credit per individual is $3,000 in the first year of employment and $1,500 in the second year of employment. The employer's deduction for wages is reduced by the amount of the credit (determined without regard to the tax liability limitation on the credit). Thus, for a corporate employer that hires an eligible employee who earns $6,000 in the first year of employment, the credit results in an actual tax reduction that ranges from $1,620 (for an employer in the 46-percent bracket) to $2,520 (for an employer in the 16-percent bracket). However, because all wages are deductible for employees who are not members of target groups, after-tax costs of the first $6,000 of wages paid to an employee if the credit were not available would range from $3,240 (for an employer in the 46-percent bracket) to $5,040 (for an employer in the 16-percent bracket). Thus, the credit provides a 50-percent reduction in the after-tax costs of the first $6,000 of wages paid to target group employees in the first year of employment, regardless of the employer's tax bracket.

According to U.S. Department of Labor data, 563,381 certifications of targeted group eligibility were issued during fiscal year 1984. This total excludes certifications of economically disadvantaged cooperative education students. Of the 563,381 certifications, almost 60 percent were economically disadvantaged youths aged 18 to 24, and 15 percent were AFDC recipients and WIN registrants.

Though there is no comprehensive information, it is expected that much of the credit goes to labor intensive industries and especially those which hire large numbers of minimum wage workers, such as the fast food industry.

Rationale

The credit is designed to increase employment especially among categories of workers who experience the greatest difficulty in finding jobs. It reduces the negative impact of the minimum wage upon employment of economically disadvantaged youth, and it encourages employers to invest time and effort in training those previously unemployable for work.

Selected Bibliography

Bishop, John, ed. *Subsidizing On-The-Job Training: An Analysis of a National Survey of Employers.* Ohio: National Center for Research in Vocational Education, 1980.

Fisk, John, updated by Linda LeGrande. *The Economic Rationale of the Targeted Jobs Tax Credit.* Report No. 83-16E. Library of Congress, Congressional Research Service. Jan. 26, 1983.

Haveman, Robert H. and John L. Palmer, eds. *Jobs for Disadvantaged Workers: The Economics of Employment Subsidies.* Washington: The Brookings Institution, 1982.

LeGrande, Linda. *Other Nations' Experience With Categorical Employment Subsidies: Are There Options Suggested for the United*

States? Report No. 85–547E. Library of Congress, Congressional Research Service, Feb. 4, 1985.

McIntosh, Barbara. "Employment Subsidies: An Examination of TJTC and State Extensions in New England." The Northeast Journal of Business and Economics, v. 10, No. 2, spring/summer 1984: 35–50.

O'Neill, Dave M. "Employment Tax Credit Programs: The Effects of Socio-Economic Targeting Provisions." Journal of Human Resources, v. 17, No. 3, summer 1982: 449–459.

U.S. Congress. Congressional Budget Office. *Staff Memorandum on the Targeted Jobs Tax Credit,* by Sandra Christensen. May 1984.

———. Senate. Committee on Finance. *Description of the Targeted Jobs Tax Credit and S. 2185 ("Job Opportunity Act of 1983").* Committee Print. 98th Cong., 2d sess., Feb. 29, 1984.

———. *Targeted Jobs Tax Credit.* Hearing. 98th Cong., 2d sess., Mar. 2, 1984.

U.S. General Accounting Office. *Targeted Jobs Tax Credit Program Activity.* Memo, PAD–83–44, June 8, 1983.

PARENTAL PERSONAL EXEMPTION FOR STUDENTS AGE 19 OR OVER

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	1.2		1.2
1987	1.2		1.2
1988	1.3		1.3
1989	1.3		1.3
1990	1.4		1.4
1991	1.5		1.5

Authorization

Section 151(e).

Description

A taxpayer is allowed to deduct $1,040 as an exemption for each dependent. A person with gross income in excess of $1,040 may not be claimed as a dependent unless that person is the child of the taxpayer and is either (a) less than 19 years of age or (b) a full-time student. (These dollar figures are indexed for inflation.) Unless support is provided by several taxpayers, a person is a dependent only if the taxpayer claiming him as a dependent provided more than one-half of the person's support.

Impact

This provision benefits families with tax liability and with children who are students and have earnings. The value of each $1,040 personal exemption deduction is $520 for families with the highest marginal tax rate of 50 percent and $114 for those with the lowest marginal rate. No relief is available to the parents of students who provide more than one-half of their own support. Therefore, parents are aided by this dependency exemption if their student-children do not rely on their earnings or other income to provide a majority of their support.

Rationale

A personal exemption for dependents was first provided by the Revenue Act of 1918, apparently to provide some tax relief for parents supporting young children or students. The definition of a dependent was revised over the years, and a gross income test was added in 1944, disallowing the deduction for parents if the dependent earned more than a specified amount. The 1954 revision of the Internal Revenue Code eliminated the gross income test for dependent children under the age of 19 and dependent children of any age who were students. The main reason for the change was to avoid the "notch" problem that resulted when a dependent's earnings were close to the exemption amount; an extra few dollars in earnings could deprive the parents of the exemption, costing them hundreds of dollars in extra taxes. Except for increases in the amount of the exemption to $1,000 and the adjustment of this dollar amount for inflation beginning in 1985, this provision has been unchanged since 1954.

Selected Bibliography

Groves, Harold M. *Feberal Tax Treatment of the Family.* Washington, D.C.: The Brookings Institution, 1963: 39–43.

Harris, C. Lowell. "Parent and Child—and Taxes: Some Problems in Dependency," in: U.S. Congress. House. Committee on Ways and Means. *Tax Revision Compendium.* Committee Print. 1959: 531–535.

Seltzer, Lawrence H. *The Personal Exemption in the Income Tax.* New York: National Bureau of Economic Research, 1968: 113–120.

U.S. Congress. House. *Internal Revenue Code of 1954.* Report No. 1337, 83d Cong., 2d sess., 1954: 18–19.98th Cong., 2nd sess., Dec. 31, 1984: 858–859.

(500) Education, Training, Employment, and Social Services

EMPLOYER EDUCATIONAL ASSISTANCE

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	(1)		(1)
1987			
1988			
1989			
1990			
1991			

[1] Less than $50 million.

Authorization

Section 127.

Description

An employee may exclude from gross income up to $5,000 annually of the value of amounts paid by employers for educational assistance pursuant to a qualified educational assistance program. Amounts that may be excluded by an employee include amounts paid by an employer for tuition, fees, and similar payments, as well as the cost of books, supplies, and equipment.

For a program to qualify as a qualified educational assistance program, the employees must not be able to choose taxable benefits in lieu of educational assistance benefits. Furthermore, an educational assistance program must not discriminate in favor of employees who are officers, owners, or highly compensated (or their dependents). The benefits of this provision are scheduled to terminate for amounts paid in taxable years beginning after December 31, 1985.

Impact

Employer-provided education may constitute a significant portion of an employee's compensation. The value of the exclusion is greater for employees in higher marginal tax brackets.

Rationale

Prior to the enactment of the exclusion in 1978, the treatment of employer-provided educational assistance added to the complexity of the tax system and sometimes acted as a disincentive to continuing education. The complexity resulted because employer-provided educational assistance was treated as wages to the employee and a case-by-case determination of whether the employee could deduct the assistance as job-related education was required. The exclusion allows certain employees, who otherwise might be unable to do so, to continue their education. However, the exclusion benefits only those employees whose employers maintain educational assistance programs.

Selected Bibliography

Mylan, John J. "Current Tax Treatment of Educational Costs." University of Florida Law Review, v. 32, spring 1980: 387–423.

U.S. Congress. Joint Committee on Taxation. *General Explanation of the Revenue Act of 1978*, Mar. 12, 1979: 124–128.

Weber, Richard P. "Education Expenses and Taxes: Inequities and Taxpayer Opportunities." Taxes, v. 58, No. 3, Mar. 1980: 154–164.

EXCLUSION OF CERTAIN MEALS AND LODGING FURNISHED BY NON-MILITARY EMPLOYERS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	0.9		0.9
1987	1.0		1.0
1988	1.0		1.0
1989	1.1		1.1
1990	1.2		1.2
1991	1.3		1.3

Authorization

Sections 119 and 132(e)(2).

Description

Meals.—Section 119 excludes from gross income the fair market value of meals furnished to an employee (or to the employee's spouse or dependents) by or on behalf of the employer for the convenience of the employer if the meals are furnished on the employer's business premises. Under section 132(e)(2), as added by the Tax Reform Act of 1984, the fair market value of meals provided to an employee at a subsidized eating facility operated by the employer is excluded from income as de minimis fringes if (1) the facility is located on or near the employer's business premises, (2) revenue from the facility equals or exceeds direct operating costs, and (3) in the case of highly compensated employees, certain nondiscrimination requirements are met.

Lodging.—Section 119 excludes from an employee's gross income the fair market value of lodging provided by the employer if (1) the lodging is furnished for the convenience of the employer, (2) the lodging is on the business premises of the employer, and (3) the employee is required to accept the lodging as a condition of employment.

Impact

Meals and lodging furnished by an employer may, in certain circumstances, constitute a large portion of the employee's compensation (e.g., in the case of a live-in housekeeper or an apartment resident manager). To the extent that money wages are lower as a result of the tax benefit from excluding certain meals and lodging, employment is subsidized in occupations that involve this type of in-kind income.

Rationale

The convenience-of-the-employer exclusion now set forth in section 119 generally had been reflected in income tax regulations since 1918, presumably in recognition of the fact that in some cases, the fair market value of employer-provided meals and lodging may be difficult to measure. The specific statutory language in section 119 was adopted in the 1954 Code to clarify the tax status of such benefits by more precisely defining the conditions under which meals and lodging are treated as tax free.

In enacting the limited exclusion for certain employer-provided eating facilities in the 1984 Act, the Congress recognized that the benefits provided to a particular employee who eats regularly at such a facility might not qualify as a de minimis fringe, and hence would be taxable absent another specific statutory exclusion. The recordkeeping difficulties involved in identifying which employees ate what meals on particular days, as well as the values and costs for each such meal, led the Congress to conclude that an exclusion should be provided for subsidized eating facilities as defined in section 132(e)(2).

Further Comment

The difficulty in some circumstances of determining the fair market value of these benefits is cited as a major argument against including them in income. On the other hand, this argument is challenged by others who cite the fact that a value is placed on these payments under many State welfare laws.

Selected Bibliography

Guttentag, Joseph H., E. Deane Leonard, and William Y. Rodewald. "Federal Income Taxation of Fringe Benefits: A Specific Proposal." National Tax Journal, v. 16, Sept. 1953: 250–272.

Kahn, C. Harry. *Employee Compensation Under the Income Tax.* New York: National Bureau of Economic Research, 1968: 82–87.

Layne, Jonathan Keith. "Cash Meal Allowances Are Includible in Gross Income and Are Not Excludible Under I.R.C. Section 119 as That Section Permits an Exclusion Only for Meals Furnished in Kind." Emory Law Review, v. 27, summer 1978: 791–814.

Sunley, Emil M., Jr. "Employee Benefits and Transfer Payments," in: Joseph A. Pechman, ed. *Comprehensive Income Taxation.* Washington, D.C.: The Brookings Institution, 1977: 90–92.

U.S. Congress. Joint Committee on Taxation. *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984.* Committee Print. 98th Cong., 2nd sess., Dec. 31, 1984: 858–859.

(500) Education, Training, Employment, and Social Services

EXCLUSION OF CONTRIBUTIONS TO PREPAID LEGAL SERVICES PLANS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	(1)		(1)
1987	(1)		(1)
1988			
1989			
1990			
1991			

[1] Less than $50 million.

Authorization

Sections 120 and 501(c)(20).

Description

Amounts contributed by an employer to a qualified group legal services plan for employees, as well as any services received by an employee or any amounts paid to an employee under such a plan as reimbursement for legal services for the employee, are excluded from the employee's income. This exclusion applies to plans established to provide personal legal services for employees, their spouses, and their dependents through prepayments of, or advance provision for, legal fees. Sole proprietors and partners are considered employees for purposes of the exclusion. Plans must be organized through tax-exempt organizations or trusts or established through insurance companies. To qualify, plans must not discriminate in favor of officers, shareholders, highly compensated employees, or self-employed individuals with respect to eligibility and benefits.

This provision applies to taxable years ending before January 1, 1986.

Impact

The tax treatment afforded these plans is similar generally to that provided group life insurance plans and accident and health plans set up by employers for their employees. The value of the exclusion increases with increases in the marginal tax rate of the employee. Group legal programs and similar arrangements were not widely used prior to enactment of these tax provisions in 1976. Although no comprehensive statistics are available, indications are that the number of these plans has grown as a result of the tax incentive.

Rationale

This tax treatment of group prepaid legal services plans was adopted in 1976 to grant taxpayers some relief from the high cost of legal fees, and to promote the adoption of such plans by employers and employees. Congress believed it was desirable to increase the availability of legal services to middle-income taxpayers whom they considered to be the most under-represented economic group in terms of legal services. Higher income taxpayers generally can afford to pay their own legal expenses, while lower income persons, in some areas, may have access to publicly supported legal aid services.

Selected Bibliography

Licker, Eugene. "Tax Policies in Relation to Nonbusiness Legal Expenses and Prepaid Legal Services: The Inequities of New Sections 120 and 501(c) 20 of the I.R.C. and a Call for a Deduction for All Nonbusiness Legal Expenses." American University Law Review, winter 1977: 451–498.

Leibig, Michael T. and William A. Bolger. "The Development and Taxation of Group Legal Services: Is a Surge Coming?" Journal of Pension Planning and Compliance, v. 8, May 1982: 163–196.

Nolan, John S. "Taxation of Fringe Benefits." National Tax Journal, v. 30, Sept. 1977: 359–368.

U.S. Congress. House. Committee on Ways and Means. *Exclusion for Group Legal Services Plans and Miscellaneous Tax Bills.* Hearing. 98th Cong., 2nd sess., Apr. 12, 1984.

———. Joint Committee on Taxation. *General Explanation of the Economic Recovery Tax Act of 1981.* Dec. 29, 1981: 358.

———. *General Explanation of the Tax Reform Act of 1976.* Dec. 29, 1976: 666–672.

EXCLUSION FOR EMPLOYER-PROVIDED CHILD CARE

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	(1)		(1)
1987	(1)		(1)
1988	.01		0.1
1989	.1		.1
1990	.1		.1
1991	.1		.1

[1] Less than $50 million.

Authorization

Section 129.

Description

Payments by an employer for dependent care assistance provided to an employee are excluded from the employee's gross income, if the assistance is provided under a plan which meets certain conditions. These conditions include eligibility conditions which do not discriminate in favor of officers, owners, and highly compensated individuals, and reasonable notification of the availability of the benefits to eligible employees.

Impact

The exclusion provides an incentive for employers to provide, and employees to receive, compensation in the form of dependent care assistance rather than cash. As is the case with all deductions and exclusions, this incentive is higher for taxpayers in higher marginal tax brackets.

Rationale

This provision, enacted in the Economic Recovery Tax Act of 1981, was intended to provide an incentive for employers to become more involved in the provision of dependent care for their employees.

Selected Bibliography

Brenner, Annette J. and David S. Iskowe. "Taxpayers With Dependents and Their Employers Both Have Tax Planning Opportunities." Taxation For Accountants, v. 30, Mar. 1983: 160–164.

Burud, Sandra L., Pamela R. Aschbacher and Jacquelyn McCroskey. *Employer-Supported Child Care: Investing in Human Resources.* Boston: Auburn House Publishing Co., 1984.

Commerce Clearing House. *Tax Incentives for Employer-Sponsored Day Care Programs.* Chicago, Ill.: Commerce Clearing House, Inc., 1980.

Nolan, John S. "Taxation of Fringe Benefits." National Tax Journal, v. 31, Sept. 1977: 359–368.

U.S. Congress. Joint Committee on Taxation. *General Explanation of the Economic Recovery Tax Act of 1981.* Dec. 29, 1981: 53–56.

Senate. Committee on Labor and Human Resources. *Private Sector Initiatives.* Hearing. 98th Cong., 1st sess., Nov. 16, 1983.

EMPLOYEE STOCK OWNERSHIP PLANS (ESOP's)

Estimated Revenue Loss [1]

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986		2.3	2.3
1987		2.6	2.6
1988		1.7	1.7
1989		.7	.7
1990		.2	.2
1991		(1)	(1)

[1] Less than $50 million.

Authorization

Sections 44G, 44(a)(2)(A), 48(n), 133, 401(a), 404(k), 1042, 2210, and 4978.

Description

In general

An employee stock ownership plan (ESOP) is a qualified stock bonus plan or a combination stock bonus and money purchase pension plan that may be utilized as a technique of corporate finance and under which employer stock is held for the benefit of employees. The stock, which is held by one or more tax-exempt trusts under the plan, may be acquired through direct employer contributions or with the proceeds of a loan to the trust (or trusts). Gain realized on the sale of employer securities to an ESOP is generally taxed at capital gain rates.

An ESOP that borrows to acquire employer stock is referred to as a leveraged ESOP. Under a leveraged ESOP, amounts contributed by the employer and applied by the plan to the payment of interest on a loan incurred to purchase employer securities are deductible within limits.

Tax credit

A corporation is allowed a tax credit for a contribution to an ESOP that meets certain standards (a tax credit ESOP). The credit is limited to a prescribed percentage of the aggregate compensation of all employees under the plan. For compensation paid or accrued in calendar years 1983 through 1987, the tax credit is limited to one-half of 1 percent. No credit is provided with respect to compensation paid or accrued after December 31, 1987.

Tax credit ESOP's are subject to many of the rules that apply to qualified pension and stock bonus plans, but are subject also to special rules designed to provide additional safeguards for the interests of employees. For example, in contrast to pension and profit-sharing plans that may provide deferred vesting, benefits under tax credit ESOP's vest immediately.

Stock held under a tax credit ESOP generally must remain in the trust for at least 7 years, after which it can be distributed to the employees.

Dividend deduction

Effective for years beginning after July 18, 1984, an employer is entitled to deduct the amount of any dividends paid in cash during the employer's taxable year with respect to stock of the employer that is held by an ESOP (including a tax credit ESOP) but only to the extent such dividends are actually paid out currently to participants or beneficiaries.

Deferral of gain on stock sold to employee organizations

A taxpayer may elect to defer recognition of gain on the sale of certain qualified securities to an employee stock ownership plan (ESOP) or to an eligible worker-owned cooperative to the extent that the taxpayer reinvests the proceeds in qualified replacement property within a replacement period. To be eligible for nonrecognition treatment, (1) the qualified securities must be sold to an employee organization; (2) the employee organization must own, immediately after the sale, at least 30 percent of the total value of the employer securities then ouststanding; (3) the employee organization must preclude allocation of assests attributable to qualified securities to certain individuals; and (4) the taxpayer must provide certain information to the Secretary of the Treasury. To preclude the employee organization from disposing of the qualified securities within 3 years of the date of the sale, an excise tax measured by dispositions or distributions that reduce the organization's interest in employer securities to less than 30 percent is imposed on the employer maintaining the ESOP or on the eligible worker-owned cooperative.

Partial exclusion of interest on ESOP loans

A bank, insurance company, or a corporation actively engaged in the business of lending money may exclude from gross income 50 percent of the interest received with respect to a securities acquisition loan. A securities acquisition loan means any loan to a corporation or to an ESOP to the extent that the proceeds are used to acquire employer securities for the plan.

ESOP assumption of estate tax liabilities

If qualified employer securities (1) are acquired from a decedent by an ESOP or an eligible worker-owned cooperative, (2) pass from a decedent to an ESOP or worker-owned cooperative, or (3) are transferred by the decedent's executor to an ESOP or worker-owned cooperative, present law generally relieves the executor of the decedent's estate of the estate tax liability to the extent the ESOP or cooperative is required to pay the liability.

To the extent that (1) the decedent's estate is otherwise eligible to make deferred payments of estate taxes pursuant to section 6166 with respect to the decedent's interest in qualified employer securities, and (2) the executor elects to make payments pursuant to that section, then the plan administrator of the ESOP or an authorized officer of the worker-owned cooperative may also elect to pay any estate taxes attributable to the qualified employer securities transferred to the ESOP or cooperative in installments pursuant to that section.

Impact

Tax credit

Because a corporation is granted a credit equal to its contribution to a tax credit ESOP, the contribution has no cost to the corporation and is financed entirely by the Federal Government. By comparison, contributions to regular pension, profit-sharing, or stock bonus plans are made directly by the employer and resemble wage costs. Furthermore, in contrast to pension plans in general, only corporate employers are entitled to this tax credit. Employees of sole proprietors and partnerships cannot benefit.

Dividend deduction

By permitting a deduction for those dividends on employer stock held by an ESOP that are paid to participants, this provision encourages current distribution of those dividends.

Deferral of gain on stock sold to employee organizations

Deferring the tax on gains realized on sales of stock to eligible employee organizations encourages business owners to sell their business interests to employees rather than other investors because gain realized on sales to other investors generally would be taxed at the time of sale.

Partial exclusion of interest on ESOP loans

The partial exclusion of interest on ESOP loans provides eligible lenders with interest income that, under normal circumstances, would be taxable as ordinary income. Because the interest is partially tax exempt, lenders are willing to accept lower before-tax rates of interest than on loans generating taxable interest. By financing ESOP borrowing through loans eligible for the exclusion, the ESOP or the sponsoring employer can lower its borrowing costs.

Because it is an exclusion from income, the value of this tax expenditure increases with the marginal tax bracket of the lender.

ESOP assumption of certain estate tax liabilities

By permitting an ESOP or eligible worker-owned cooperative to assume the estate tax liability attributable to employer securities acquired from a decedent, the provision encourages the sale or other disposition of employer securities to employee organizations rather than other investors. To the extent the estate is otherwise eligible to make deferred payments of estate tax, the ESOP also would be permitted to pay its assumed estate tax liability in installments (interest payments for 4 years, followed by up to 10 annual installments of principal and interest). Moreover, the ESOP would be entitled to have a pro rata portion of its estate tax liability subject to the special 4 percent interest rate applicable to the first $1 million of value in a closely held business. Thus, the ESOP's acquisition of employer securities would, in essence, be financed by the Federal Government and financed, in part, at the special 4 percent rate.

Rationale

Tax credit

A temporary additional investment tax credit for contributions to employee stock ownership plans first was provided by the Tax Reduction Act of 1975 to encourage the growth of these types of plans. The purpose of the provision was to provide funds for the purchase of corporate stock by employee trusts allowing employees to share in the ownership of corporate capital and in the growth and profitability of the employer. However, because of the temporary nature of the tax credit and rules that could have resulted in some instances in corporations paying for contributed stock themselves, few plans were established before the 1976 Tax Reform Act. These plans became more widespread with the revisions in the Tax Reform Act of 1976, which extended and expanded the investment-based credit in general, and which eliminated any risk of costs of the trusts being borne by employers.

In the Economic Recovery Tax Act of 1981, the payroll-based tax credit was substituted for the investment-based credit to encourage labor-intensive corporations to establish tax credit ESOP's.

Dividend deduction; deferral of gain on stock sold to employee organizations; partial exclusion of interest on ESOP loans; ESOP assumption of certain estate tax liabilities

The provisions permitting (1) a deduction for certain dividends on ESOP stock paid to participants; (2) deferral of gain realized on the sale of qualified securities to an eligible employee organization; (3) a partial exclusion of interest on certain ESOP loans; and (4) ESOP assumption of certain estate tax liabilities first were added by the Deficit Reduction Act of 1984 because the Congress believed that it is appropriate to provide additional tax incentives to encourage employee stock ownership.

Selected Bibliography

Carlson, D. Bret. "ESOPs and Universal Capitalism." Tax Law Review, v. 31, spring 1976: 289–315.

Miller, John J. "ESOPs, TRASOPs, and PAYSOPs: A Guide for the Perplexed." Management Review, v. 72, Sept. 1983: 40–43.

Reicher, Richard. "Deficit Reduction Act Makes Significant Changes to Rules Governing ESOPs." Journal of Taxation, v. 62, Feb. 1985: 70–75.

U.S. Congress. Joint Committee on Taxation. *General Explanation of the Economic Recovery Tax Act of 1981.* Dec. 29, 1981: 219–225.

———. *General Explanation of the Revenue Act of 1978.* Dec. 29, 1976: 85–93.

———. *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984.* Committee Print. 98th Cong., 2nd sess., Dec. 31, 1984: 21–22, 873–882.

———. Senate. *Technical Corrections Act of 1979.* Report. No. 96–498. 96th Cong., 2nd sess., Dec. 13, 1979: 15–30.

———. Committee on Finance. *ESOPs and TRASOPs: An Explanation for Employees.* 1978.

———. *Employee Stock Ownership Plans: An Employer Handbook.* 1980.

CAFETERIA PLANS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	0.3	....	0.3
1987	1.0	....	1.0
1988	1.6	....	1.6
1989	2.3	....	2.3
1990	3.0	....	3.0
1991	3.7	....	3.7

Authorization

Section 125.

Description

In general, the cafeteria plan rules provide that a participant in a nondiscriminatory cafeteria plan is not treated as having received a taxable benefit offered under the plan solely because the participant had the opportunity, before the benefit became available, to choose among the taxable and nontaxable benefits offered under the plan. Taxable benefits that may be offered under a qualified cafeteria plan consist of certain life insurance that is not excludable from gross income, certain vacation pay, or cash. Nontaxable benefits include any fringe benefit (other than scholarships or fellowships, vanpooling, educational assistance, or miscellaneous fringe benefits) that is excludable from gross income under a specific section of the Code. These nontaxable benefits include nontaxable employer-provided health and accident benefits and life insurance.

A highly compensated participant in a cafeteria plan is treated as having received available cash and taxable benefits if the cafeteria plan discriminates in favor of highly compensated individuals as to eligibility or as to benefits or contributions. A highly compensated individual includes an officer, a 5-percent shareholder, a highly compensated individual, or a spouse or dependent of any of the preceding individuals. In addition, if more than 25 percent of the total nontaxable benefits provided under a cafeteria plan for a plan year are provided to employees who are key employees with respect to the plan for the year, such key employees will be taxed as though they received all available taxable benefits under the plan. A key employee is an individual who is an officer, a 5-percent owner, a 1-percent owner earning more than $150,000, or one of the top 10 employee-owners.

Impact

This provision permits an employer to allow each employee individual flexibility to choose benefits from a menu of benefits. Thus, an employer with a set amount allocated to provide employee benefits may offer a wider range of benefits, permitting each employee to choose those best suited to their individual circumstances.

Rationale

Under a provision of the Employee Retirement Income Security Act of 1974 (ERISA), an employer contribution made before January 1, 1977, to a cafeteria plan in existence on June 27, 1974, was required to be included in an employee's gross income only to the extent that the employee actually elected taxable benefits. In the case of a plan not in existence on June 27, 1974, the employer contribution was required to be included in income to the extent the employee could have elected taxable benefits. Under the Tax Reform Act of 1976, these rules applied with respect to employer contributions made before Janury 1, 1978. The Foreign Earned Income Act of 1978 (Public Law 95-615) extended these rules until the effective date of the Revenue Act of 1978 (i.e., it extended the treatment through 1978 for calendar year taxpayers). In the Revenue Act of 1978, the provision was added to the Code to ensure that rules were provided on a permanent basis.

In the Deficit Reduction Act of 1984, the Congress found it appropriate to limit permissible benefits and provide additional reporting requirements. Reports accompanying that legislation note that these additional limitations were needed to prevent further erosion of the income and employment tax bases.

Selected Bibliography

Irish, Leon E. "Cafeteria Plans in Transition." Tax Notes, v. 25, Dec. 17, 1984: 1127-1141.

Knox, Peter L. "Cafeteria Plans: New Law Removes Proposed IRS Restrictions and Adds Certainty to Operations." Taxation for Accountants, v. 33, Sept. 1984: 168-172.

Stull, Gregory J. "Elective Compensation: Cafeteria Plans." Taxes, v. 63, Mar. 1985: 210-220.

U.S. Congress. Joint Committee on Taxation. *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984.* Committee Print. 98th Cong., 2d sess., Dec. 31, 1984: 867-872.

EXCLUSION FOR PARSONAGE ALLOWANCES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	0.1		0.1
1987	.1		.1
1988	.2		.2
1989	.2		.2
1990	.2		.2
1991	.2		.2

Authorization

Section 107.

Description

Under a special exclusion, a gross income does not include (1) the fair rental value of a home furnished to a minister as part of compensation, or (2) cash rental allowance paid to a minister as part of compensation, to the extent the allowances are used to rent or provide a home.

Prior to the issuance of an IRS ruling in January 1983, ministers receiving such housing allowances also could claim deductions for mortgage interest and real estate taxes on their residences even though such expenditures were allocable, in whole or in part, to tax-free receipt of the allowances. The Tax Reform Act of 1984 permits ministers who owned or occupied their homes before January 3, 1983 to continue claiming such deductions allocable to tax-free housing allowances through December 31, 1985.

Impact

As a result of the special exclusion provided for parsonage allowances, ministers receiving such housing allowances pay less tax than other taxpayers with the same or smaller economic incomes. Thus, a minister with a salary of $19,000 and a $4,000 cash housing allowance stands in the same economic position and has the same ability to pay tax as another taxpayer (such as a teacher) earning $23,000 in taxable income and spending $4,000 on housing. The Federal income tax liability of the minister is lower, however, because of the exclusion from gross income of the parsonage allowance. Also, the tax benefit of the exclusion provides a disproportionately greater benefit to relatively better-paid ministers, by virtue of the higher marginal tax rates applicable to their incomes.

To the extent that some ministers may (through 1985) claim deductions for housing costs allocable to tax-free allowances, such individuals effectively receive a double benefit; i.e., as a result of the same activity, they receive both tax-free support and tax deductions that may be used to offset other income. This result is inconsistent with general tax policy of preventing double tax benefits.

Rationale

The exclusion for parsonage allowances has been provided since 1921, presumably on the ground that ministers are generally low paid.

The transitional relief through 1985 allowed under the 1984 Act to ministers who had purchased homes prior to 1983 was intended to provide time for such ministers to seek additional compensation from their employers or to make other adjustments to neutralize the effect of disallowing double tax benefits.

Selected Bibliography

O'Neill, Thomas E. "A Constitutional Challenge to Section 107 of the Internal Revenue Code." Notre Dame Lawyer, v. 57, June 1982: 853-867.

EXCLUSION OF MISCELLANEOUS FRINGE BENEFITS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	3.3		3.3
1987	3.6		3.6
1988	3.8		3.8
1989	4.1		4.1
1990	4.5		4.5
1991	4.8		4.8

Authorization

Sections 132 and 117(d).

Description

Under the Tax Reform Act of 1984, certain miscellaneous fringe benefits provided by an employer are excluded from the recipient employee's gross income for Federal income tax purposes and from the wage and benefit bases for purposes of social security and other employment taxes. The excluded fringe benefits are those that qualify under one of the following five categories as defined in the act: (1) a no-additional-cost service, (2) a qualified employee discount, (3) a working condition fringe, (4) a de minimis fringe, or (5) a qualified tuition reduction. Special rules apply with respect to certain parking facilities provided to employees and certain on-premises athletic facilities.

These provisions of the 1984 act generally took effect on January 1, 1985, except that the tuition reduction exclusion applies with respect to education furnished after June 30, 1985.

Impact

In the absence of well-defined limits on the ability of employers to compensate employees tax-free by providing noncash benefits having economic value, the income tax base could be significantly eroded. This is because the preferential tax treatment of fringe benefits serves as a strong motivation to employers to substitute more and more types of benefits for cash compensation. A similar shrinkage of the base of the social security payroll tax could also pose a threat to the viability of the social security system, beyond the adverse projections addressed in the Social Security Amendments of 1983. In addition, the utilization of noncash forms of compensation shifts a disproportionate tax burden to those individuals whose compensation is in the form of cash.

The tax law, to the extent it provides tax-free treatment for noncash compensation, increases inequities among employees in different types of businesses, because not all employers can or will provide comparable compensation packages. For example, consumer-goods retail stores can offer their employees discounts on clothing, hardware, etc.; by contrast, a manufacturer of aircraft engines cannot give its workers compensation in the form of tax-free discounts on its products. Similarly, an unlimited exclusion for noncash benefits discriminates among employers. For example, if tax-free discounts were allowed across all lines of business of an employer, a large employer with many types of businesses (e.g., department store, hotel, airlines, etc.) would be given a favorable edge by the tax system in competing for employees as compared with a small firm having one line of business (e.g., a specialty clothing store). Also, a failure to put any limits on the untaxed status of fringe benefits would encourage employers to provide further noncash forms of compensation and thus, in effect, restrict the employees' freedom of choice over how to spend or save their compensation.

Rationale

In enacting the section 132 exclusion for certain miscellaneous fringe benefits, the Congress was aware that in many industries, employees may receive, either free or at a discount, goods and services that the employer sells to the general public. In many cases, these practices have been long established, and generally had been treated by employers, employees, and the Internal Revenue Services as not giving rise to taxable income.

Although employees receive an economic benefit from the availability of these free or discounted goods or services, it was believed that employers often have valid business reasons, other than simply providing compensation, for encouraging employees to avail themselves of the products that those employees sell to the public. For example, a retail clothing business will want its salespersons to wear, when they deal with customers, the clothing that it seeks to sell to the public, rather than clothing sold by its competitors. In addition, where an employer has only one line of business, the fact that the selection of goods and services offered in that line of business may be limited in scope makes it appropriate to provide a limited exclusion, when such discounts are generally made available to employees, for the income employees realize from obtaining free or reduced-cost goods or services. By contrast, allowing tax-free discounts for all lines of business of a conglomerate organization, where the employee might have unlimited choices among many products and services that individuals normally consume or use on a regular basis, could be indistinguishable in economic effect from allowing tax-free compensation in the form of cash or gift certificates.

Selected Bibliography

Kies, Kenneth J. "Analysis of the New Rules Governing the Taxation of Fringe Benefits." Tax Notes, v. 2, Sept. 3, 1984: 981–989.

McKinney, James E. "Certainty Provided as to the Treatment of Most Fringe Benefits by Deficit Reduction Act." Journal of Taxation, v. 61, Sept. 1984: 134–137.

U.S. Congress. Joint Committee on Taxation. *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984.* Committee Print. 98th Cong., 2d sess., Dec. 31, 1984: 838–866.

———. Senate. Committee on Finance. *Fringe Benefits.* Hearings. 98th Cong., 2d sess., July 26–27, 30, 1984.

CREDIT FOR CHILD AND DEPENDENT CARE EXPENSES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	2.2		2.2
1987	2.7		2.7
1988	3.0		3.0
1989	3.4		3.4
1990	3.9		3.9
1991	4.4		4.4

Authorization

Section 21.

Description

A taxpayer who maintains a household is allowed a nonrefundable tax credit for employment-related expenses incurred for the care of a dependent child under age 15, a disabled dependent, or a disabled spouse. The maximum credit is 30 percent of expenses up to (1) $2,400 (for a maximum credit of $720) annually for one qualifying individual, and (2) $4,800 (for a maximum credit of $1,440) annually for two or more qualifying individuals, in the case of taxpayers with adjusted gross income of $10,000 or less. The rate of the credit is reduced by 1 percentage point for each $2,000 of income, or fraction thereof, above $10,000 until the lowest rate (20 percent) is reached for taxpayers with incomes above $28,000.

Employment-related expenses that are incurred outside the taxpayer's household may be taken into account if they are for the care of a physically or mentally incapacitated spouse or dependent of the taxpayer who regularly spends at least 8 hours each day in the taxpayer's household, or if they are for the care of a dependent of the taxpayer who is under the age of 15. Expenses that are incurred for services provided by a dependent care center may be taken into account only if the center complies with all applicable State and local laws and regulations. The credit is permitted for payments to relatives of the taxpayer regardless of whether they live in or outside the taxpayer's household, provided they are not dependents of the taxpayer or children of the taxpayer who have attained age 19.

Impact

The credit benefits qualified taxpayers with sufficient tax liability to take advantage of it, without regard to whether or not they itemize their deductions. The credit does not benefit persons with income so low that they have no tax liability.

Because the credit rate phases down from 30 to 20 percent as income rises from $10,000 to $28,000, the credit targets greater benefits toward low- and middle-income taxpayers.

Rationale

A deduction for child and dependent care services first was enacted in 1954. The allowance was limited to $600 per year and was phased out for families with income between $4,500 and $5,100. The intent of the provision was to provide for the deduction of expenses comparable to an employee's business expenses in cases where taxpayers must incur such expenses.

The provision was made more generous in 1964, and was modified in 1971. Several new justifications were specified for the provision in 1971, including encouraging the hiring of domestic workers, encouraging the care of incapacitated persons at home rather than in institutions, providing relief to middle income taxpayers as well as low income taxpayers, and providing relief for employment-related expenses of household services as well as for dependent care. Thus, there was a departure from the earlier intent that only essential expenditures for such services should be deductible.

The Tax Reduction Act of 1975 substantially increased the income limits for taxpayers who could claim the deduction.

In 1976, the deduction was replaced by a nonrefundable credit against taxes. Congress believed that (1) such expenses should be viewed as a cost of earning income for *all* taxpayers and that it was wrong to deny the benefits to those taking the standard deduction, (2) the tax credit would provide relatively more benefit than the deduction to taxpayers in the lower brackets, (3) the prior rules governing married couples, divorced and separated persons, and payments to relatives were unduly restrictive, and (4) computation of the deduction was too complex.

The Revenue Act of 1978 eliminated the requirement that child care services performed by relatives must constitute employment within the meaning of the social security tax definition in order, to qualify as creditable expenses.

In 1981, the provision was converted into a sliding-scale credit that phases down from 30 to 20 percent as income rises from $10,000 to $28,000. Moreover, the maximum amounts eligible for the credit were increased. The purpose of switching to a sliding-scale credit was to target the increases in the credit toward low- and middle-income taxpayers.

Selected Bibilography

Greenwald, Carol S. and Linda G. Martin. "Broadening the Child Care Deduction: How Much Will It Cost?" New England Economic Review, Sept./Oct. 1974: 22–30.

Hargrave, Eugenia. "Income Tax Treatment of Child and Dependent Care Costs: The 1981 Amendments." Tax Law Review, v. 60, Feb. 1982: 321–354.

Keane, John B. "Federal Income Tax Treatment of Child Care Expenses." Harvard Journal of Legislation, v. 10, Dec. 1972: 1–40.

Klein, William A. "Tax Deductions for Family Care Expenses." Boston College Industrial and Commercial Law Review, v. 14, May 1973: 917–941.

Krashinsky, Michael. "Subsidies to Child Care: Public Policy and Optimality." Public Finance Quarterly, v. 9, July 1981: 243–269.

U.S. Congress. Joint Committee on Taxation. *General Explanation of the Economic Recovery Tax Act of 1981.* Dec. 1981: 53–56.

———. *General Explanation of the Revenue Act of 1978.* Mar. 12, 1979: 63–65.

———. *General Explanation of the Tax Reform Act of 1976.* Dec. 29, 1976: 123–127.

(500) Education, Training, Employment, and Social Services

DEDUCTION FOR TWO-EARNER MARRIED COUPLES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	6.8		6.8
1987	6.9		6.9
1988	7.4		7.4
1989	7.9		7.9
1990	8.5		8.5
1991	9.2		9.2

Authorization

Section 221.

Description

Two-earner married couples who file joint returns are allowed a deduction from gross income equal to 10 percent (5 percent in 1982) of the qualified earned income of the lesser earning spouse. The maximum deduction is $1,500 in 1982 and $3,000 thereafter. Taxpayers may claim this deduction even if they do not itemize their deductions.

Impact

This provision reduces the marriage penalty and in some cases increases the marriage bonus. The penalty or bonus equals the difference in tax liability for two-earner married couples between filing as one joint return or as two single returns.

Rationale

Both present and prior law only allow married couples to file a joint return even when it would be advantageous for them to file as single taxpayers because these couples usually pool their income and consume as a unit. Prior law upheld the principle of taxing couples with equal incomes equally. However, in the case of couples earning more than $20,000 and with the lesser earning spouse accounting for more than 20 percent of their combined earned income, the marriage penalty and marginal tax rates were quite high because the second income was taxed starting at the highest marginal tax rate on the first income. This proved to be a strong economic incentive against the second spouse going to work. It also undermined the family and the tax system by encouraging annual divorce and remarriage or avoidance of marriage altogether.

Selected Bibliography

Brazer, Harvey E. "Income Tax Treatment of the Family," in: Henry J. Aaron and Michael J. Boskin, eds. *The Economics of Taxation.* Washington, D.C.: The Brookings Institution, 1980: 223–246.

Feenberg, Daniel and Harvey S. Rosen. "Alternative Tax Treatment of the Family: Simulation Methodology and Results." National Bureau of Economic Research Working Paper No. 497, July 1980.

Gallagher, Thomas. "The Treatment of Marital Status in the Federal Personal Income Tax." Multilith No. 79-115E. Washington, D.C.: The Library of Congress, Congressional Research Service, Apr. 27, 1979.

Gann, Pamela B. "The Earned Income Deduction: Congress' 1981 Response to the Marriage Penalty Tax." Cornell Law Review, v. 68, Apr. 1983: 468–487.

McIntyre, Michael J., and Oliver Oldman. "Treatment of the Family," in: Joseph A. Pechman, ed. *Comprehensive Income Taxation.* Washington D.C.: The Brookings Institution, 1977: 205–241.

Munnell, Alicia. "The Couple Versus the Individual Under the Federal Personal Income Tax," in: Henry J. Aaron and Michael J. Boskins, eds. *The Economics of Taxation.* Washington, D.C.: The Brookings Institution, 1980: 247–278.

Stromquist, Walter. "Federal Income Tax Treatment of Married and Single Taxpayers." Tax Notes, v. 7, June 11, 1979: 731–736.

Thomas, K. Arthur. "Marriage Tax 'Reform': An Analysis of the Reagan Proposal." Tax Notes, v. 12, Aug. 10, 1981: 259–264.

U.S. Congress. Joint Committee on Taxation. *General Explanation of the Economic Recovery Tax Act of 1981.* Dec. 29, 1981: 33–34.

———. Senate. *The Income Tax Treatment of Married Couples and Single Persons.* Report Prepared by the Staff of the Joint Committee on Taxation for the Use of the Committee on Ways and Means, U.S. House of Representatives and the Committee on Finance. Committee Print. 96th Cong., 2d sess., Apr. 2, 1980.

Winn, Jeanette Anderson and Marshall Winn. "Till Death Do We Split: Married Couples and Single Persons Under the Individual Income Tax." South Carolina Law Review, v. 34, 1983: 829–883.

(500) Education, Training, Employment, and Social Services

DEDUCTION FOR ADOPTION EXPENSES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	(1)		(1)
1987	(1)		(1)
1988	(1)		(1)
1989	(1)		(1)
1990	(1)		(1)
1991	(1)		(1)

[1] Less than $50 million.

Authorization

Section 222.

Description

A taxpayer may take an itemized deduction for adoption expenses paid or incurred in connection with the adoption of a child with special needs; *that is,* generally a child (1) who the State has determined cannot or should not be returned to the home of the natural parents, and (2) who, because of a specific factor or condition, cannot reasonably be expected to be adopted unless adoption assistance is provided under the Social Security Act. The maximum deduction with respect to the adoption of any one child is $1,500.

Impact

Adoption expenses which include adoption fees, court costs, attorneys fees, and other expenses related to the legal adoption of a child can be very high. These expenses, coupled with the problems of children with special needs, provided a major obstacle to the adoption of children with special needs. This provision reduces the financial burden in connection with the adoption of children with special needs.

Rationale

Adoption expenses traditionally have been considered as nondeductible personal expenses. The adoption expense deduction, which was enacted in 1981, is intended to reduce the obstacles in connection with the adoption of children with special needs by reducing the financial burdens in connection therewith.

Selected Bibliography

U.S. Congress. Joint Committee on Taxation. *General Explanation of the Economic Recovery Tax Act of 1981.* Dec. 29, 1981: 57–58.

(500) Education, Training, Employment, and Social Services

DEDUCTIBILITY OF CHARITABLE CONTRIBUTIONS

Estimated Revenue Loss

(1) EDUCATIONAL INSTITUTIONS

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	0.8	0.5	1.3
1987	.8	.6	1.4
1988	.7	.7	1.4
1989	.8	.7	1.5
1990	.9	.1	1.6
1991	.9	.8	1.7

(2) HEALTH INSTITUTIONS

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	1.6	0.3	1.9
1987	1.7	.3	2.0
1988	1.5	.3	1.8
1989	1.6	.3	1.9
1990	1.7	.4	2.1
1991	1.9	.4	2.3

(3) OTHER THAN EDUCATIONAL AND HEALTH INSTITUTIONS

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	11.2	0.5	11.7
1987	11.6	.6	12.2
1988	10.2	.6	10.8
1989	11.0	.7	11.7
1990	11.8	.7	12.5
1991	12.9	.8	13.7

Authorization

Sections 170 and 642(c).

Description

Subject to certain limitations, individuals, corporations, trusts, and estates are allowed income tax deductions for contributions of cash or property to or for the benefit of charitable, religious, educational, and certain other specified types of nonprofit organizations, or Federal, State, and local governments.

An individual taxpayer who itemizes deductions may claim the amount of allowable charitable deductions in computing deductions from adjusted gross income. In addition, the Economic Recovery Tax Act of 1981 provided a charitable deduction for nonitemizers, to be phased in over a 5-year period and then terminated after 1986.

Under the phase-in for taxable years beginning in 1982–84, the amount of contributions that nonitemizers may take into account is subject to a dollar cap; in addition, for the years 1982–85, only a percentage of the amount of contributions otherwise deductible is allowed as a deduction for nonitemizers. These percentages and dollar caps are shown in the following table:

Year	Percentage	Contribution cap
1982	25	$100
1983	25	100
1984	25	300
1985	50	
1986	100	
1987	(1)	(1)

[1] Provision scheduled to expire.

Impact

The deduction for charitable contributions reduces tax liability, and thus makes the net cost to the taxpayer of contributing less than the amount of the gift. In effect, the Federal Government provides the donee with a matching grant that, per dollar of contribution, increases in value with the donor's tax bracket. Thus, a taxpayer in the 50-percent bracket who itemizes deductions can contribute $100 to a charitable organization at a net cost of $50, while one in the 20-percent bracket can contribute the same amount at a net cost of $80.

Types of contributions may vary substantially among income classes. Contributions to religious organizations are more concentrated at the lower end of the income scale than contributions to hospitals, the arts, and educational institutions, with contributions to other types of organizations falling between these levels. The volume of donations to religious organizations is greater than to all other organizations as a group. The volume of giving to educational and health institutions is relatively low.

Organizations that receive the contributions (and their beneficiaries) benefit from this provision to the extent it increases charitable giving. Empirical studies have not reached a consensus as to precisely how much the deduction encourages charitable contributions and how the deduction affects the composition of contributions. Particularly in the case of relatively modest contributions, charitable giving also depends on factors such as general donative desire, attendance at religious activities, membership in educational, environmental, etc., organizations, desire to repay benefits from schools or community organizations, and financial status.

Rationale

The charitable deduction has long been allowed by the income tax law as an encouragement to charitable giving.

Selected Bibliography

Abrams, Burton A. and Mark D. Schmite. "The Crowding-Out Effect of Governmental Transfers of Private Charitable Contributions: Cross-Section Evidence." National Tax Journal, v. 37, Dec. 1984: 563–568.

Bittker, Boris. "Charitable Contributions: Tax Deductions or Matching Grants?" Tax Law Review, v. 27, fall 1972: 37–63.

Brannon, Gerard M. "The Charitable Deduction Plus the Standard Deduction: Good Tax Policy or Not?" Tax Notes, v. 11, Oct. 2, 1978: 387–389.

Browne, Kingsbury. "Federal Tax Policy Developments Affecting the Conservation of Critical Lands: Growing Restraints on Local Initiatives." Policy Studies Journal, v. 12, Mar. 1984: 547–560.

Clotfelter, Charles T. and Lester M. Salamon. *The Federal Government and the Nonprofit Sector: The Impact of the 1981 Tax Act on Individual Charitable Giving.* Washington, D.C.: The Urban Institute, Aug. 1981.

Commission on Private Philanthropy and Public Needs. *Giving in America: Toward a Stronger Voluntary Sector.* Washington, D.C., 1975.

Due, John F. "Personal Deductions," in: Joseph A. Pechman, ed. *Comprehensive Income Taxation.* Washington, D.C.: The Brookings Institution, 1977: 37–74.

Feldstein, Martin and Lawrence Lindsey. *Simulating Nonlinear Tax Rules and Nonstandard Behavior: An Application to the Tax Treatment of Charitable Contributions.* National Bureau of Economic Research Working Paper No. 682, May 1981.

Hasson, James K., Jr. "Foundations and Other Charities Benefit From New Law Despite Its Restrictions." Journal of Taxation, v. 61, Dec. 1984: 392–398.

McDaniel, Paul R. "Federal Matching Grants for Charitable Contributions: A Substitute for the Income Tax Deduction." Tax Law Review, v. 27, spring 1972: 377-413.

O'Hare, Michael and Alan L. Feld. "Indirect Aid to the Arts." *Paying for Culture.* Philadelphia: American Academy of Political and Social Science, 1984. Annals, v. 471, Jan. 1984: 132-143.

Schenk, Deborah H. "The Complexity Costs of the Above-the-line Charitable Contributions." Tax Notes, v. 17, May 5, 1980: 651-653.

Surrey, Stanley R. *Pathway to Tax Reform.* Chapter VII—"Three Special Tax Expenditure Items: Support to State and Local Governments, to Philanthropy, and to Housing." Cambridge, Mass.: Harvard University Press, 1973.

Thuronyi, Victor. "Extending the Charitable Deduction to Nonitemizers." Tax Notes, Apr. 21, 1980: 563-566.

U.S. Congress. House. Committee on Ways and Means. *Computer Contribution Act of 1983.* Hearing. 98th Cong., 1st sess., Nov. 11, 1983.

———. Joint Committee on Taxation. *General Explanation of the Economic Recovery Tax Act of 1981.* Dec. 29, 1981: 49-50.

———. *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984.* Committee Print. 98th Cong., 2d sess., Dec. 31, 1984: 666-706, 1133-1156.

Vandell, Kerry D. and Michael O'Hare. "Indirect Government Aid to the Arts: the Tax Expenditure in Charitable Contributions." Public Finance Quarterly, v. 7, Apr. 1979: 162-181.

(550) Health

EXCLUSION OF EMPLOYER CONTRIBUTIONS FOR MEDICAL INSURANCE PREMIUMS AND MEDICAL CARE

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	23.7		23.7
1987	26.3		26.3
1988	28.9		28.9
1989	32.0		32.0
1990	35.5		35.5
1991	39.2		39.2

Authorization

Section 106.

Description

Employees do not pay tax on their employer's contributions to accident and health plans (through insurance or otherwise) that provide compensation for sickness and injury.

Impact

The exclusion from tax of employer contributions to employee health insurance plans benefits all taxpayers who participate in employer-subsidized plans. A recent survey indicates that about 75 percent of all persons with private health coverage in the United States participate in such plans. The exemption allows employers to provide their employees with health insurance coverage at less cost then if employees were paid additional taxable wages in amounts sufficient to purchase the same amount of insurance. Employees are encouraged to seek additional health insurance coverage, since its net after-tax cost is less to them than alternative purchases that must be made with taxable income. This expanded health insurance coverage has led, many believe, to excessive use of health care services, which in turn has helped to drive up health care costs.

While the exclusion benefits a relatively wide range of the population, it provides proportionately greater benefits to persons with higher incomes, both because they tend to have larger employer-paid health insurance premiums that are excluded from taxation and because they are in higher marginal tax brackets. In addition, because the plan of an employer is not required to cover employees on a nondiscriminatory basis (as is the case with most other fringe benefits), the benefit of the exclusion can be limited to only selected employees or can be more generous for selected employees.

Rationale

Originally, employer contributions to employee health plans were not subject to tax, because noncash fringe benefits were generally considered not to be taxable income. In 1943, an Internal Revenue Service (IRS) ruling made this exemption explicit for employer contributions to group health insurance policies. Employer contributions to individual health insurance policies, however, were declared to be taxable income in an IRS revenue ruling in 1953. Section 106, which was introduced in 1954, was enacted to reverse the 1953 ruling. As a result, all employer contributions to employee health and accident plans are now excluded from taxable income.

The legislative history of section 106 indicates that its purpose was principally to make uniform the tax treatment of employer contributions to group and individual health insurance plans. It also has the effect, as indicated above, of encouraging the expansion of health insurance coverage, although that was not originally its major purpose.

Selected Bibliography

Blinder, Alan S. and Harvey S. Rosen. "Notches." Cambridge, Mass.: National Bureau of Economic Research, 1984. Working Paper No. 1416.

Davis, Karen. *National Health Insurance: Benefits, Costs and Consequences.* Washington, D.C.: The Brookings Institution, 1975.

Employee Benefit Research Institute. *Revising the Federal Tax Treatment of Employer Contributions to Health Insurance: A Continuing Debate.* Washington, D.C.: Employee Benefit Research Institute, 1983, EBRI issue brief No. 21.

Feldstein, Martin and Bernard Friedman. "Tax Subsidies, the Rational Demand for Insurance and the Health Care Crisis." Journal of Public Economics, v. 7, Apr. 1977: 155–178.

Feldstein, Martin and Elizabeth Allison. "The Tax Subsidies of Private Health Insurance: Distribution, Revenue Loss and Effect," in: U.S. Congress. Joint Economic Committee. *The Economics of Federal Subsidy Programs.* Part 8—"Selected Subsidies." July 29, 1974: 977–994.

Goode, Richard. *The Individual Income Tax.* Rev. ed. Washington, D.C.: The Brookings Institution, 1976: 156–160.

Nolan, John S. "Taxation of Fringe Benefits." National Tax Journal, v. 30, Sept. 1977: 359–368.

Steurle, Eugene and Ronald Hoffman. "Tax Expenditures for Health Care." National Tax Journal, v. 32, June 1979: 101-114.

U.S. Congress. Congressional Budget Office. *Tax Subsidies for Medical Care: Current Policies and Possible Alternatives.* 1980.

———. House. Committee on the Budget. Subcommittee on Oversight. Task Force on Tax Expenditures and Tax Policy. *Tax Expenditures for Health Care.* Hearings. 96th Cong., 1st sess., July 9-10, 1979.

———. Joint Committee on Taxation. *Overview of Adminstration Proposal to Cap Exclusion for Employer Provided Medical Care and Tax Treatment of Other Fringe Benefits.* Committee Print. 98th Cong., 1st sess., June 21, 1983.

Vogel, Ronald. "The Tax Treatment of Health Insurance Premiums as a Cause of Overinsurance," in: M. Pauly, ed. *National Health Insurance: What Now, What Later, What Never?* Washington, D.C.: American Enterprise Institute for Public Policy Research, 1980.

Wilensky, Gail R. "Government and the Financing of Health Care." American Economic Review, v. 82, May 1982.

Wilensky, Gail R. and Amy K. Taylor. "Tax Expenditures and Health Insurance: Limiting Employer-Paid Premiums." Public Health Reports, v. 97, Sept.-Oct. 1982: 438-444.

(550) Health

DEDUCTIBILITY OF MEDICAL EXPENSES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	3.5	....	3.5
1987	3.5	....	3.5
1988	3.9	....	3.9
1989	4.3	....	4.3
1990	4.8	....	4.8
1991	5.3	....	5.3

Authorization

Section 213.

Description

Medical expenses paid by an individual, including qualified medical insurance premiums, may be itemized and deducted from income to the extent they exceed 5 percent of adjusted gross income (AGI). There is an additional limitation in computing medical expenses with respect to medicine and drugs; only amounts paid for insulin or prescribed drugs may be deducted.

Impact

For the 39 percent of taxpayers who itemize their deductions, the medical expense deduction serves to ease the financial burden of extraordinary and involuntary expenses. The deduction is not limited to involuntary expenses, however; it also covers the cost of cosmetic surgery, rest cures, and other optional expenses. In fact, with the substantial expansion of health insurance coverage in recent years, a significant share of the out-of-pocket medical expenses now deducted is for procedures that are not generally reimbursed by insurance because they are considered discretionary. Like the exclusion for employer-paid health insurance premiums, the medical expense deduction encourages the use of medical services, thereby helping to bid up their price. And like all deductions, the medical expense deduction produces higher tax savings per dollar of deduction for taxpayers in higher income tax brackets.

Rationale

Health costs in excess of a given floor were first allowed as a deduction in 1942 in order to maintain high standards of public health and to ease the burden of high wartime tax rates. Originally, the deduction was allowed only to the extent that medical expenses exceeded 5 percent of AGI—considered to be the average family medical expense level—and was subject to a $2,500 maximum. In 1951, the floor was removed for taxpayers 65 or over. In 1954, when the Internal Revenue Code was substantially revised, the percentage of AGI floor was reduced to 3 percent and the 1-percent floor was imposed on drugs and medicines. The dollar ceiling was increased several times until it was finally eliminated in 1965. Also, in 1965 the aged were made subject to the floor. In 1982, the floor was raised to 5 percent of adjusted gross income and the 1-percent drug and medicine floor was replaced with the prescribed drugs and insulin requirement of current law.

Selected Bibliography

Davis, Karen. *National Health Insurance: Benefits, Costs, and Consequences.* Washington, D.C.: The Brookings Institution, 1975.

Feldstein, Martin and Elizabeth Allison. "The Tax Subsidies of Private Health Insurance: Distribution, Revenue Loss and Effect," in: U.S. Congress. Joint Economic Committee. *The Economics of Federal Subsidy Programs.* Part 8—"Selected Subsidies." July 29, 1974: 977-994.

Goode, Richard. *The Individual Income Tax.* Rev. ed. Washington, D.C.: The Brookings Institution, 1976: 156-160.

Mitchell, B. M. and R. J. Vogel. *Health and Taxes: An Assessment of the Medical Deduction,* R-1222-OEO. Santa Monica, Calif.: The Rand Corp., Aug. 1973.

Steurle, Eugene and Ronald Hoffman. "Tax Expenditures for Health Care." National Tax Journal, v. 32, June 1979: 101-114.

U.S. Congress. Congressional Budget Office. *Tax Subsidies for Medical Care: Current Policies and Possible Alternatives.* 1980.

———. House. Committee on the Budget. *Tax Expenditures for Health Care.* Hearings. 96th Cong. 1st sess., July 9-10, 1979.

———. Joint Committee on Taxation. *General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982.* Committee Print. 97th Cong., 2d sess., Dec. 31, 1984: 24-25.

Vogel, Ronald. "The Tax Treatment of Health Insurance Premiums as a Cause of Overinsurance," in: M. Pauly, ed. *National Health Insurance: What Now, What Later, What Never?* Washington, D.C.: American Enterprise Institute for Public Policy Research, 1980.

Wilensky, Gail R. "Government and the Financing of Health Care." American Economic Review, v. 82, May 1982.

(550) Health

EXCLUSION OF INTEREST ON STATE AND LOCAL HOSPITAL BONDS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	NA	NA	NA
1987	2.4	0.2	2.6
1988	2.8	.2	3.0
1989	3.2	.2	3.4
1990	3.8	.2	4.0
1991	4.4	.2	4.6

Authorization

Sections 103 (a) and (b) of the Internal Revenue Code of 1954 and Revenue Ruling 63-20.

Description

The interest on bonds issued by State and local governments to finance construction of both public and private hospitals may be excluded from gross income regardless of issue size. The bonds issued for construction of privately owned hospitals are backed by the revenues received from the facilities built with the bond proceeds. Interest on the bonds is tax exempt because in form, if not in substance, the bonds are a debt of a State or local government.

Impact

Tax-exempt hospital bonds subsidize the cost of hospital construction. Because the interest is tax exempt, the issuer can offer bonds at lower interest rates than a private hospital would pay if it issued taxable bonds. Reported hospital bond sales have increased dramatically in recent years, from $3.6 billion in 1980 to $6.8 billion in 1983, accounting for approximately 7.3 percent of all new long-term tax-exempt financing in that year. Tax-exempt bonds finance about half of all new hospital construction, and approximately three-fourths of all bonds issued are for privately owned facilities. The use of tax-exempt bonds to finance medical equipment has been growing especially rapidly in recent years.

Rationale

The use of tax-exempt bonds for hospital construction has generally been permitted on the grounds that they serve a public purpose. Before 1968, any hospital construction could be financed with tax-exempt bonds because the tax code did not prohibit the use of industrial development bonds for nonexempt, for-profit institutions. Since 1968, when restrictions were placed on the use of IDB's, proprietary medical institutions have been subject to the rules governing small issue IDB's. (For further details, see the section on the Exclusion of Interest on State and Local Industrial Development Bonds.) Tax-exempt not-for-profit hospitals may issue bonds themselves if they meet the requirements of revenue ruling 63–20, or local agencies may issue tax-exempt bonds for them under sections 103(a) or 103(b) of the tax code. Tax-exempt bonds may be issued for construction, remodeling and capital equipment.

Under the Deficit Reduction Act of 1984, IDB's for nonexempt, for-profit hospitals are subject to the overall volume limitations for private activity tax-exempt bonds. The amount of all such bonds that may be issued by a State during any given year is equal to the greater of (1) the product of $150 times the number of residents of the State, or (2) $200 million. Bonds to finance public hospitals, or private tax-exempt, not-for-profit hospitals, are not subject to the volume cap.

Further Comment

The necessity of providing subsidies for new hospital construction has come into question because of the current national surplus of hospital beds. Excess hospital capacity has resulted in short cutbacks in direct Federal subsidies for hospital construction. The main argument against repealing the tax exemption for private hospital bonds is that some areas still lack adequate hospital facilities, even though nationally the supply of hospital beds is more than sufficient. A possible solution may be to permit the use of hospital bonds in areas that have a shortage of adequate facilities. Another, and possibly preferable, solution would be to provide direct subsidies to areas with shortages. Direct subsidies may be a less expensive and more efficient alternative, since the entire subsidy would go to the institution, rather than a substantial portion flowing to bondholders, underwriters, and bond counsel as under any tax-exempt bond provision.

Selected Bibliography

Lamb, Robert and Steven P. Rappaport. "Tax-Exempt Bonds for Hospitals," in: *Municipal Bonds: The Comprehensive Review of Tax-Exempt Securities and Public Finance.* McGraw-Hill Book Co., New York, 1980: 185–206.

"Medical Care" (The tax-exempt issuance for hospitals and other medical projects in 1984, including a ranking of the leading managers). *The Bond Buyer's Municipal Statebook 1984:* 51–83.

U.S. Congress. Congressional Budget Office. *Tax Subsidies for Medical Care: Current Policies and Possible Alternatives,* 1980: 47–61.

(550) Health

TAX CREDIT FOR ORPHAN DRUG RESEARCH

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986		(1)	(1)
1987		(1)	(1)
1988		(1)	(1)
1989		(1)	(1)
1990		(1)	(1)
1991		(1)	(1)

[1] Less than $50 million.

Authorization

Section 28.

Description

A tax credit is available for 50 percent of qualified clinical testing expenses that are necessary to obtain the approval of the Food and Drug Administration for the commercial sale of drug for a rare disease. Expenses that qualify for the orphan drug research credit cannot also qualify for the research expenditure credit. The credit is available for qualified clinical testing procedures regardless of whether the taxpayer elects to expense or amortize research expenditures under Code Section 174. However, amounts expensed or amortized under Code Section 174 are limited if the orphan drug research credit is claimed.

Impact

For purposes of this section, qualified clinical testing expenses refer to expenses which qualify as qualified research expenses under section 30's credit for increased research activities. Examples of such expenses are in house expenditures for wages, supplies and rentals of personal property used in certain types of human clinical testing. Other such expenses include all contract research expenses paid to any person by the taxpayer for clinical testing conducted on the taxpayers behalf.

Of course, any expenditures funded by any grant contract or otherwise by another person or any governmental entity are ineligible for orphan drug research credit.

These restrictions on eligibility for the credit are in keeping with the credits purpose of encouraging research into areas concerning rare diseases or conditions which might not otherwise be undertaken. The determination of what is a rare disease is made on the basis of the facts and circumstances existing as of the date such drug is designated under Section 526 of the Federal Food, Drug, and Cosmetic Act. Such rare diseases occur so infrequently in the United States that there is no reasonable expectation of the taxpayer recouping costs of the development of the drug from sales of the drug in the United States. Among the diseases and conditions considered rare in the United States are Huntington's disease, myoclunus, ALS (Lou Gehrig's disease), Tourrette's syndrome and muscular dystrophy.

Selected Bibliography

Grossman, Donna Brown. "The Orphan Drug Act: Adoption or Foster Care?" Food Drug Cosmetic Law Journal, v. 39, Apr. 1984: 128-151.

U.S. Congress. House. Committee on Energy and Commerce. *Orphan Drug Act: Report to Accompany H.R. 5238.* Including cost estimate of the Congressional Budget Office. 97th Cong., 2d sess., Report No. 97-840.

EXCLUSION OF UNTAXED SOCIAL SECURITY BENEFITS

Disability Insurance Benefits, OASI Benefits for Retired Workers, and Benefits for Dependents and Survivors

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	DI benefits	OASI benefits for retired workers	Benefits for dependents and survivors
1986	1.1	NA	NA
1987	1.1	15.9	1.5
1988	1.2	16.9	1.6
1989	1.3	18.0	1.7
1990	1.4	19.1	1.8
1991	1.4	20.3	1.9

Authorization

Sec. 86 I.R.C. 1954 and I.T. 3194, 1938-1 C.B. 114 and I.T. 3229, 1938-2136, as superseded by Rev. Rul. 69-43, 1969-1 C.B. 310; I.T. 3447, 1941-1 C.B. 191, as superseded by Rev. Rul. 70-217, 1970-1 C.B. 12.

Description

Social security benefit payments to persons who are aged or disabled and to dependents and survivors of persons receiving retirement benefits are taxed to the extent a certain level of income is achieved. Benefits are included in taxable income for taxpayers whose adjusted gross income (AGI) combined with tax-exempt interest and one-half of their social security benefits exceeds $25,000 for a single taxpayer, $32,000 for a married couple filing jointly or zero for a married couple filing separately. In such cases, the amount added to taxable income is the lesser of one-half of (1) the designated benefits or (2) the amount by which AGI plus one-half of the benefits exceeds the $25,000 or $32,000 figure, whichever applies. In this respect, the tax treatment differs from that of other pension benefits, which are fully taxable after the annuitant has recovered his or her own contributions.

Impact

The elderly benefit most from this treatment, since most social security payments are made to the elderly (see table above). Because the partial exclusion of benefits is worth more to taxpayers the greater their marginal tax rate, recipients with substantial amounts of taxable income benefit more than do most others.

Rationale

The exemption for social security payments has never been established by statute; it derives from administrative ruling I.T. 3447, issued in 1941. A Supreme Court decision in 1937 and a 1938 IRS ruling regarding lump sum payments may have been influential in resolving the issue. In 1937, the Supreme Court characterized social security as "general welfare" (*Helvering* v. *Davis,* 301 U.S. 619, 640). Two 1939 rulings made lump sum distributions nontaxable (I.T. 3194 and I.T. 3229); internal memoranda suggested that the payments were considered in the nature of a gift. The reasons underlying the 1941 IRS ruling on monthly payments appear to include: (1) the benefits are gratuities and thus not subject to income tax because gifts are not taxable; (2) the Congress indicated its intent that the benefits not be taxable since it did not specifically make them taxable; and (3) the benefits are in the nature of public assistance for the general welfare and the Congress did not intend to tax with one hand what it pays out with the other. In the Social Security Amendments of 1983, Congress enacted the current formula to tax those social security recipients who earned a substantial amount of income other than social security payments.

Further Comment

If Social Security payments received the same tax treatment as private pension benefits, about 83 percent of benefits on average would be included in taxable income, although this figure could vary considerably depending on an individual's circumstances. The 1979 Advisory Council on Social Security recommended that half of benefits should be taxed. Taxing half of benefits would bring the tax treatment of social security closer to that of private sector pensions, and would probably also be administratively simpler for the Social Security Administration and the IRS than trying to apply the precise private pension rules. In the Social Security Amendments of 1983, Congress provided that those social security recipients who received other income in excess of $25,000 ($32,000 on a joint return) would be subject to tax on one-half of their social security benefits.

Selected Bibliography

Goode, Richard B. *The Individual Income Tax.* Rev. ed. Washington, D.C.: The Brookings Institution, 1976: 103–107.

Groves, Harold Martin. *Federal Tax Treatment of the Family.* Washington, D.C.: The Brookings Institution, 1963: 47–55.

———. *Federal Tax Treatment of the Family,* Chapter III—Tax Treatment of the Aged and Blind. Washington, D.C.: The Brookings Institution, 1963.

Koitz, David. *Social Security: The Taxfree Status of Benefits.* Multilith No. 79-247 EPW. Washington, D.C.: The Library of Congress, Congressional Research Service, Nov. 30, 1979.

Levy, Mickey D. *The Tax Treatment of Social Security: Should the Exclusion of Benefits be Eliminated?* AEI studies, 267. Washington, D.C.: American Enterprise Institute for Public Policy Research, 1980.

———. *The Tax Treatment of Social Security,* American Enterprise Institute, 1979.

Munnell, Alicia. *The Future of Social Security.* Washington, D.C.: The Brookings Institution, 1977: 30.

Myers, Robert Julius. *Social Security.* Sec. ed. Homewood, Ill.: R. D. Irwin for McCahan Foundation, 1981: 359-360.

———. *Paying for Social Security: Funding Options for the Near Term.* Congressional Budget Office, February 1981: 45-47.

U.S. Congress. House. Committee on Ways and Means. *Report of the 1979 Advisory Council on Social Security.* Transmitted by the Secretary of Health, Education, and Welfare, Dec. 7, 1979. 1980: 6, 74-76, 209.

———. Subcommittee on Social Security. *Background Material on Options for Financing the Social Security Programs.* 1979: 17-21.

U.S. President's Commission on Pension Policy. *Coming of Age: Toward a National Retirement Income Policy.* 1981: 3, 47-48.

U.S. Congress. House of Representatives. Conference Report No. 98-147. *Social Security Amendments of 1983,* Mar. 24, 1983.

EXCLUSION OF UNTAXED RAILROAD RETIREMENT SYSTEM BENEFITS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	0.5		0.5
1987	.5		.5
1988	.5		.5
1989	.5		.5
1990	.5		.5
1991	.5		.5

Authorization

45 U.S.C. 228, Railroad Retirement Act of 1935 as amended; Social Security Act Amendments of 1983, Railroad Retirement Solvency Act of 1983; Section 86 IRC 1954.

Description

The railroad retirement system is the federally administered retirement system for railroad employees. The basic railroad retirement benefit is designed to be equivalent to social security.

To conform the tax treatment of railroad retirement benefits to social security benefits, the Congress provided for the taxation of railroad retirement benefits of certain taxpayers. Railroad retirement benefits are included in taxable income for taxpayers whose adjusted gross income (AGI) combined with tax exempt interest and one-half of their railroad retirement benefits exceeds $25,000 for a single taxpayer, $32,000 for a married couple filing jointly or zero for a married person filing separately. In such cases, the amount added to taxable income shall be the lesser of one-half of (1) the designated benefits or (2) the amount by which AGI plus one-half of the benefits exceeds specified base amounts. In this respect, the tax treatment differs from that of other pension benefits which are fully taxable after the annuitant has recovered his or her own contributions.

Impact

The partial exclusion benefits only retired members of the railroad retirement system and their dependents. Because the retirement benefits are composed of elements of both social security and private pensions, tax-free payments to recipients are generally larger than those under social security. In fact, benefits typically paid newly retired members significantly exceed after-tax income earned just before retirement.

Rationale

While this partial exclusion has a statutory foundation, the reasons supporting it have not been stated. Presumably they are similar to those stated for social security.

Further Comment

Railroad retirement benefits replace a larger portion of wages, after tax, than do nearly all other benefits paid to blue collar workers. (At present, benefits for new retirees with spouses may often exceed $20,000.)

Selected Bibliography

Goode, Richard, *The Individual Income Tax*. Rev. ed. Washington, D.C.: The Brookings Institution, 1976: 103–107.

Groves, Harold. *Federal Tax Treatment of the Family*, Chapter III—"Tax Treatment of the Aged and Blind" Washington, D.C.: The Brookings Institution, 1963.

U.S. Congress. Congressional Budget Office. *The Railroad Retirement System: Benefits and Financing*. 1981: 31–32.

U.S. Congress. House of Representatives. Conference Report No. 98-147. *Social Security Amendments of 1983*. Mar. 24, 1983.

EXCLUSION OF UNTAXED WORKMEN'S COMPENSATION BENEFITS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	2.4	....	2.4
1987	2.4	....	2.4
1988	2.7	....	2.7
1989	3.0	....	3.0
1990	3.3	....	3.3
1991	3.7	....	3.7

Authorization

Section 104(a)(1).

Description

Workers' compensation benefits are not taxable. (To the extent workmen's compensation benefits received reduce social security benefits received, the workmen's compensation benefits shall be treated as social security benefits.)

Impact

The provision reduces tax burdens during periods of illness. It also exempts benefits for permanent injuries. The benefit amounts are specified by State law (in contrast to the sick pay exclusion, where payments are subject to the employer's discretion).

Rationale

A rationale for this provision is not offered in the committee reports accompanying its enactment in 1918.

Further Comment

The level of workers' compensation is specified by law and is related to salary level. Minimum and maximum benefits levels apply. Payments are based on degree of disability and may be related to family size, but not to the amount of other family income, including any earnings of the beneficiary.

Selected Bibliography

Goode, Richard. *The Individual Income Tax.* Rev. ed. Washington, D.C.: The Brookings Institution, 1976: 107–109.

Wentz, Roy. "Appraisal of Individual Income Tax Exclusions," in: U.S. Congress. House. Committee on Ways and Means. *Tax Revision Compendium.* Committee Print. 1959: 329–40.

Yorio, Edward. "The Taxation of Damages: Tax and Non-Tax Policy Considerations." Cornell Law Review, v. 62, Apr. 1977: 701–736.

EXCLUSION OF SPECIAL BENEFITS FOR DISABLED COAL MINERS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	0.1		0.1
1987	.1		.1
1988	.1		.1
1989	.1		.1
1990	.1		.1
1991	.1		.1

Authorization

30 U.S.C. 801 and Revenue Ruling 72-400, 1972-2 C.B. 75 (under sec. 104(a)(1) of the Internal Revenue Code).

Description

Payments made to coal miners or their survivors for death or disability resulting from pneumoconiosis (black lung disease) under the Federal Coal Mine Health and Safety Act of 1969 (as amended by the Black Lung Benefits Act of 1972, the Black Lung Benefits Reform Act of 1977, and the Black Lung Benefits Revenue Act of 1981) are exempt from income tax.

There are two types of black lung programs. The first involves Federal payments to coal miners and their survivors due to death or disability, payable for claims filed before July 1, 1973 (Dec. 31, 1973, in the case of survivors). Monthly cash benefits are related to the GS-2 civil service pay scale and number of dependents. This program currently provides total annual payments of around $1 billion to approximately 330,000 beneficiaries.[1]

The second program requires coal mine operators to insure payment of black lung benefits in a federally mandated workers' compensation program. Benefits include medical treatment as well as cash payments which, in general, are the same as provided under the program described above. These benefits are paid from a trust fund financed by a tax on coal production if there is no responsible operator (an operator for whom the miner worked 1 year) or if the responsible operator is in default. This program provides total annual payments of around $630 million to approximately 165,000 claimants.[2]

---

[1] Preliminary numbers for 1983 from the Statistical Abstract of U.S. 1985.

Impact

Black lung benefits are generally too low by themselves to subject the recipients to income tax liabilities. Therefore, those who benefit from the exclusion are likely to be recipients with other employment or with working spouses. In fact, one criticism of the black lung benefit program is that disability benefits continue for recipients who work in some other occupation.

Rationale

Payments made as a result of claims filed before December 31, 1972, were specifically excluded from Federal income tax by the Black Lung Benefits Act of 1972. Later payments are excluded by revenue ruling because they are considered to be in the nature of workers' compensation.

Selected Bibliography

McClure, Barbara. *Federal Black Lung Disability Benefits Program.* Report No. 81-239 EPW. Washington, D.C.: The Library of Congress, Congressional Research Service, Oct. 27, 1981.

———. *Summary and Legislative History of P.L. 97-119.* "Black Lung Benefits Revenue Act of 1981." Report No. 82-59 EPW. Washington, D.C.: The Library of Congress, Congressional Research Service. Mar. 29, 1982.

U.S. Congress. House. Committee on Education and Labor. *Black Lung Benefits Reform Act and Black Lung Benefits Revenue Act of 1977.* 1979: 1241p.

———. Committee on Ways and Means. *Black Lung Benefits Trust Report to Accompany H.R. 13167.* 1978. 95th Cong., 2d sess. House. Report No. 95-1656.

———. Senate. Committee on Finance. *Tax Aspects of Black Lung Benefits Legislation.* Hearing. 94th Cong., 2d sess., on H.R. 10706, Sept. 21, 1976.

———. Committee on Finance. Subcommittee on Taxation and Debt Management Generally. *Tax Aspects of the Black Lung Benefits Reform Act of 1977.* Hearing. 95th Cong., 1st sess., on S. 1538, June 17, 1977.

Walter, Douglas, H. "Tax Changes Effected by the Black Lung Revenue Act of 1977." Taxes, v. 56, May 1978: 251-254.

---

[2] Ibid.

EXCLUSION OF UNTAXED UNEMPLOYMENT INSURANCE BENEFITS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	1.0		1.0
1987	0.9		0.9
1988	.8		.8
1989	.8		.8
1990	.8		.8
1991	.8		.8

Authorization

I.T. 3230, 1938-2 C.B. 136, Rev. Rul. 55-652, 1955-C.B. 21, Rev. Rul. 70-280, 1970-1 C.B. 13, Rev. Rul. 73-154, 1973-1 C.B. 40, Rev. Rul. 76-63, 1976-1 C.B. 14, Rev. Rul. 76-144, Rev. Rul. 76-229, 1976-1 C.B. 19 and Section 85.

Description

Prior to 1979, Government-paid unemployment compensation benefits, while not expressly excluded from taxable income, were exempt from taxation under a series of Internal Revenue Service rulings. The Revenue Act of 1978 (Public Law 95-600) included a provision requiring that half of the sum of a single taxpayer's adjusted gross income and his unemployment benefits in excess of $20,000 ($25,000 for joint returns) be included in adjusted gross income. This change, first effective in 1979, brought the tax treatment of government-paid benefits more into line with that of private unemployment compensation, which is fully taxable to the extent that it exceeds prior contributions. In 1982, the Tax Equity and Fiscal Responsibility Act of 1982 (Public Law 97-248) changed the floor amount to $12,000 ($18,000 for joint returns).

Impact

Tax benefits from the partial exclusion of unemployment compensation depend on the size of payments and on the taxpayer's marginal tax bracket. While the partial exclusion is of little value to recipients with no other sources of income or to high-income taxpayers for whom benefits are fully taxable, it can be of substantial value to middle-income taxpayers with some investment income, an employed spouse, or earnings during part of the year.

Rationale

The exemption of any portion of government-paid unemployment compensation has never been established by statute; it derives from a series of administrative rulings beginning in the 1930's. These rulings probably reflected the longstanding policy of the Internal Revenue Service to exempt from taxation legislatively provided social welfare benefits.

Further Comment

Recent studies have suggested that as much as half of all unemployment can be traced to job losses involving only temporary layoffs where employers rehire former workers whose layoffs have been cushioned by unemployment benefits. Benefit payments to low- and middle-income workers while on layoff frequently approach after-tax income levels from working, making it easier for these workers to wait to be rehired rather than look for another job. Taxing all benefits, it is argued, would lessen this advantage and provide an incentive for unemployment recipients to seek immediate employment.

Selected Bibliography

Beck, John H. "Perverse Effects of Partial Taxation of Unemployment Benefits." National Tax Journal, v. 35, June 1982: 223-228.

Feldstein, Martin. "Unemployment Compensation: Adverse Incentives and Distributional Anomalies." National Tax Journal, v. 27, No. 2, June 1974: 231-244.

———. "Temporary Layoffs in the Theory of Unemployment." Journal of Political Economy, v. 84, Oct. 1976: 937-957.

Hamermesh, Daniel S. "Jobless Pay and the Economy." *Policy Studies in Employment and Welfare,* No. 29. Baltimore, Md.: Johns Hopkins University Press, 1977.

Hutchens, Robert M. "The Effect of Policy Parameter Changers on the Distribution of Unemployment Insurance Benefits." National Tax Journal, v. 32, No. 4, Dec. 1979: 513-525.

Solon, Gary. *Work Incentive Effects of Taxing Unemployment Benefits.* Cambridge, Mass.: National Bureau of Economic Research, 1984.

EXCLUSION OF PUBLIC ASSISTANCE BENEFITS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	0.5		0.5
1987	.6		.6
1988	.6		.6
1989	.6		.6
1990	.6		.6
1991	.7		.7

Authorization

No general statutory authorization. A number of revenue rulings under section 61 have declared specific types of public assistance payments excludable.

Description

The Government provides public assistance benefits tax free to individuals either in the form of cash payments or by providing certain goods and services free of charge. Cash payments come mainly from the Aid to Families with Dependent Children (AFDC) and Supplemental Security Income (SSI) programs. (Traditionally, the tax benefits from inkind payments—primarily, food stamps, medicaid, and housing assistance—have not been included as part of the tax expenditure budget because of the difficulty in determining their value to individual recipients.)

Impact

Because of the relatively low level of public assistance, cash payments and other income of recipients, most beneficiaries would have no income tax liability even if cash payments were made taxable. Recipients who benefit at all tend to be those receiving high cash payments or those employed part of the year and receiving assistance during the remainder.

Rationale

Revenue rulings generally exclude government transfer payments from income because they are considered to be general welfare payments. While no specific rationale has been advanced for this exclusion, the reasoning may be similar to that for social security payments—that they are in the nature of gifts, and that the Congress did not intend to tax with one hand what it pays out with the other.

Further Comment

Among the issues involved in the tax treatment of public assitance are whether such cash payments should be treated as taxable income, and if so, whether similar treatment should be extended to inkind benefit payments. If present levels of exemptions and the zero bracket amount are deemed to reflect a general agreement on an income level below which taxes are not to be paid, then cash payments should be treated as taxable income, just as other income sources are. Valuing Government transfers of goods and services may present some difficulty, although this would be less true for food stamps that are easily transferred among individuals than for a program like medicaid. Nonetheless, a system which taxes some types of income but not others introduces inequities among individuals with similar resources.

Tax-free benefits generally also reduce the incentives among recipients to seek employment, although the level of work response to most changes in income-tested programs appears to be slight.

Selected Bibliography

Goode, Richard. *The Individual Income Tax*. Rev. ed. Washington, D.C.: The Brookings Institution, 1976: 100–103.

Weickhardt, George G. "Income Maintenance: Nixon's FAP, McGovern's UTC, the New British Proposal, and a Recommendation." Harvard Journal on Legislation, v. 10, June 1973: 672–713.

(600) Income Security

NET EXCLUSION OF PENSION CONTRIBUTIONS AND EARNINGS

PLANS FOR EMPLOYEES AND SELF-EMPLOYED INDIVIDUALS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	56.8	....	56.8
1987	61.3	....	61.3
1988	66.9	....	66.9
1989	73.1	....	73.1
1990	79.7	....	79.7
1991	87.0	....	87.0

Authorization

Sections 401–407, 410–418E, and 457.

Description

Employer contributions to qualified pension, profit-sharing, stock bonus, and annuity plans on behalf of an employee are not taxable to the employee at the time they are made. The employer generally is allowed a current deduction for these contributions (within limits) when they are made. The earnings on the plan's assets are generally not taxed until distributed. The employee or the employee's beneficiary is generally taxed on benefits not consisting of employee contributions when the benefits are distributed. A pension, profit-sharing, or stock bonus plan is a qualified plan only if it is established by an employer for the exclusive benefit of employees or their beneficiaries. In addition, a plan must meet certain requirements including standards relating to nondiscrimination, vesting, requirements for participation, and survivor benefits. Special rules are provided for tax-sheltered annuities for employees of certain tax exempt organizations and for employees of public or tax-exempt educational institutions. The tax law also provides special limits on unfunded deferred compensation of employees of State or local governments.

Impact

The tax benefit is composed of two elements: (1) the average employee's marginal tax rate generally will be lower during retirement than during the working life because of lower income and special tax provisions for the elderly; and (2) current aggregate employer contributions and investment income which are not taxed exceed aggregate amounts paid out as taxable benefits.

Once an employee's rights to a benefit become nonforfeitable, the employee enjoys tax deferral.

The employees who benefit from this provision consist of taxpayers whose employment is covered by a plan and whose service has been sufficiently continuous for them to qualify for benefits in a company or union-administered plan. The benefit derived from the provision by a particular employee depends upon the level of tax that would have been paid by the employee if the provision were not in effect. In particular, the provision permits an upper income taxpayer to defer a greater amount of tax than a lower or middle income taxpayer because (1) the tax rate for upper income taxpayers is greater and (2) the amount of benefits on which tax is deferred is typically greater for upper income taxpayers.

The amount of plan benefits for an upper income taxpayer is typically greater because plan benefits or contributions are usually determined by reference to compensation and because of integration with social security benefits. Under a plan that is integrated with social security, employer-derived social security benefits or contributions are taken into account as if they were provided under the plan in testing whether the plan discriminates in favor of employees who are officers, shareholders, or highly compensated. For example, an integrated plan may limit plan contributions to a percentage of an employee's earnings in excess of the taxable wage base for social security taxes ($39,600 for 1985) or may reduce plan benefits by a percentage (not to exceed 83⅓ percent) of an employee's primary benefit under social security. If integration is used, the benefits or contributions will be a lower percentage of pre-retirement pay for lower income employees than for higher income employees.

Rationale

This basic treatment was adopted initially in 1921 and significantly expanded in 1942, 1974, and 1978 to provide substantial tax incentives for the establishment of nondiscriminatory retirement and incentive plans. In 1978, the rules were expanded to provide tax incentives for cash-or-deferred arrangements. Under a cash-or-deferred arrangement (401(k) plan), an employee may chose to have a portion of compensation contributed to a plan (tax deferred) or take the compensation in cash. The employee is not taxed on the portion contributed to the plan (or the income earned on the contribution) until it is distributed. The 1978 changes were designed to accommodate more flexible plans under which employees could make individual choices regarding the levels of deferred and current compensation.

In 1982, there was concern that in plans that focus benefits on key employees, the magnitude of tax incentives for qualified plans was so great that in some cases employers incurred little or no after-tax cost of providing benefits to rank-and-file employees. Accordingly, in 1982 the treatment of qualified plans was revised to require that top heavy plans (those favoring key employees) provide minimum, non-integrated benefits for non-key employees and that the plans provide more rapid vesting. The 1982 legislation also reduced the limits on contributions and benefits under plans.

Selected Bibliography

Commerce Clearing House. *Tax-Saving Plans for Self-Employed.* Pension Plan Guide No. 514. Chicago, Ill.: Commerce Clearing House, Inc., Mar. 8, 1985.

Korczyk, Sophie M. *Retirement Security and Tax Policy.* Employee Benefit Research Institute. Washington, 1984.

Munnell, Alicia. *The Economics of Private Pensions.* The Brookings Institution. Washington, D.C. 1982.

Quintiere, Gary C. et al. "Significant Employee Benefit Changes in the Tax Reform Act of 1984." Journal of Pension Planning and Compliance, v. 10, No. 5, Oct. 1984: 325–377.

Rhodes, Theodore E. and Gary G. Quintiere. "Overview of Employee Benefit Changes Under the Economic Recovery Tax Act of 1981." Journal of Pension Planning and Compliance, v. 7, Sept. 1981: 323–331.

Schmitt, Ray. *Tax-Qualified Pension Plans: Brief Summary of IRS Rules for Participation, Contributions and Distributions.* Multilith No. 85–76EPW. Washington, D.C.: The Library of Congress, Congressional Research Service, Apr. 2, 1985.

Shidler, Alan B. and Duan G. Cziok. "The 1981 Economic Recovery Tax Act: A Stimulus to Employee Benefits, Compensation and Personal Savings Programs." Journal of Pension Planning and Compliance, v. 7, Sept. 1981: 332–349.

Stein, Paul C. and Lewis Schier. "How the New Tax Law Affects Pension Plans." Journal of Pension Planning and Compliance, v. 10, No. 4, Aug. 1984: 245–256.

U.S. Congress. Joint Committee on Taxation. *General Explanation of the Tax Reform Act of 1976.* Dec. 29, 1976: 430–433.

———. *General Explanation of the Economic Recovery Tax Act of 1981.* Dec. 31, 1981: 197–215.

———. *General Explanation of the Revenue Act of 1978.* Mar. 12, 1979: 95–99.

———. *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984.* Committee Print. 98th Cong., 2d sess., Dec. 31, 1984: 807–836.

U.S. Department of the Treasury. *The President's 1978 Tax Program: Detailed Descriptions and Supporting Analysis of the Proposals.* Jan. 30, 1978: 147–163.

(600) Income Security

NET EXCLUSION OF PENSION CONTRIBUTIONS AND EARNINGS

INDIVIDUAL RETIREMENT PLANS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	NA		NA
1987	15.9		15.9
1988	17.7		17.7
1989	19.4		19.4
1990	20.9		20.9
1991	22.6		22.6

Authorization

Sections 219 and 408.

Description

An individual generally is entitled to deduct from gross income the amount contributed to an individual retirement account or annuity (IRA).

The annual deduction limit for IRA contributions is the lesser of $2,000 or 100 percent of compensation. Any individual is eligible for the deduction so long as the individual has compensation includible in gross income and has not attained age 70½ before the close of the taxable year.

A married taxpayer who is eligible to set up an IRA is permitted to make deductible contributions to an IRA for the benefit of the nonworking spouse. The maximum combined annual contribution for both spouses to the two IRA's is 100 percent of earned income or $2,250, whichever is less. In no event may a deductible contribution in excess of $2,000 be made to the account of either spouse for a year.

An employee who is a participant in a qualified pension, profit-sharing, or stock bonus plan, a tax sheltered annuity program, or a governmental plan is also allowed a deduction for qualified voluntary employee contributions made by or on behalf of the employee to the plan. The deduction allowed for contributions to an IRA for a year is reduced by the amount of deductible voluntary employee contributions to a plan.

An employee for whom an employer contributes under a simplified employee pension (SEP) is allowed a deduction for the employee's own contributions to the SEP (generally limited to the lesser of $30,000 or 15 percent of compensation). The limits on deductions for employer contributions to qualified pension, etc., plans and the overall limits on contributions and benefits under qualified plans are coordinated with the deduction limits and overall limits for SEP's.

Income and gain on amounts held under an IRA (or held by a plan as qualified voluntary employee contributions) are not taxed until distributed. Except in the case of certain correcting distributions, all distributions from IRA's are includible in gross income. Distributions made before age 59½ (other than those attributable to disability or death) are subject to an additional 10-percent income tax unless they are rolled over to another IRA or to an employer plan. If an individual borrows from an IRA or uses amounts in an IRA as security for a loan, then the transaction is treated as a distribution and the usual tax rules for distributions apply.

Impact

The tax benefit is composed of two elements: (1) the average employee's marginal tax rate will generally be lower during retirement than during the working life because of lower income and special tax provisions for the elderly; and (2) current aggregate contributions and investment income which are not taxed currently exceed aggregate amounts paid out currently as taxable benefits.

The income levels of taxpayers benefitting from IRA's are shown in the following table:

Number of Returns and Amount of Contributions to IRA's—1983

Adjusted gross income (thousands)	Number of returns (thousands)	Contributions (million)
Less than 10	645	$1,024
10 to 20	2,010	3,648
20 to 30	2,945	6,028
30 to 50	5,000	12,442
50 to 100	2,558	7,536
100 to 200	431	1,292
200 and more	130	377
Total	13,721	32,348

The extent to which IRA's encourage more saving, rather than transfers from less tax-favored forms of saving, is uncertain.

Rationale

The provision for IRA's was enacted in 1974. The purpose of IRA's was to reduce discrimination against employees who were not covered by an employer's tax-favored plan. In 1976, the benefits of IRA's were extended to a limited degree to the nonworking spouse of an eligible employee. It was thought to be unfair that the nonworking spouse of an employee eligible for an IRA did not have access to a tax-favored retirement program. In 1978, IRA's were further expanded to permit an employer to contribute an amount not to exceed $7,500 or 15 percent of compensation to a SEP subject to nondiscrimination rules. In 1981, the deduction limits for all IRA's were increased to the lesser of $2,000 or 100 percent of compensation ($2,250 for spousal IRA's) and the deduction limits for employer SEP contributions were increased to the lesser of $15,000 or 15 percent of compensation. In addition, the 1981 legislation extended the IRA program to employees who are active participants in tax-favored employer plans and permitted an IRA deduction for qualified voluntary employee contributions to an employer plan.

Selected Bibliography

Commercial Clearing House. *Individual Retirement Plans.* Pension Plan Guide No. 507, Chicago, Ill.: Commerce Clearing House, Inc., Dec. 14, 1984.

Employee Benefit Research Institute. *Individual Retirement Accounts: Characteristics and Policy Implications. EBRI issue brief No. 32.* Washington, July 1984.

———. *Retirement Program Tax Expenditures: A case of Unsubstantiated, Undocumented, Arbitrary Numbers. EBRI issue brief No. 17.* Washington, 1983: 13p.

Falk, Gene and Ray Schmitt. "Individual Retirement Accounts: Tax Incentives for Retirement Savings." Issue Brief 84104 [updated periodically] Washington, D.C.: The Library of Congress, Congressional Research Service.

Harvard Law Review Association. "Costs and Consequences of Tax Incentives: The Individual Retirement Account." Harvard Law Review, v. 94, Feb. 1981: 864–886.

U.S. Congress. Senate. Special Committee on Aging. *A Guide to Individual Retirement Accounts (I.R.A.'s).* Information paper prepared by the staff of the Special Committee on Aging, U.S. Senate. Committee Print. 97th Cong., 1st sess. 1981.

(600) Income Security

EXCLUSION OF OTHER EMPLOYEE BENEFITS

PREMIUMS ON GROUP TERM LIFE INSURANCE

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	2.1	....	2.1
1987	2.1	....	2.1
1988	2.3	....	2.3
1989	2.4	....	2.4
1990	2.5	....	2.5
1991	2.6	....	2.6

Authorization

Section 79 and L.O. 1014, 2 C.B. 8 (1920).

Description

The cost of group-term life insurance purchased by an employer for an employee for a taxable year is excluded from the employee's gross income to the extent that the amount of insurance is less than $50,000.

If a group-term life insurance plan maintained by an employer discriminates in favor of any key employee (generally an individual who is an officer, a 5-percent owner, a 1-percent owner earning more than $150,000 and one of the top 10 employee owners), the exclusion for the cost of the first $50,000 of this insurance is further limited. In the case of a discriminatory plan, the full cost of the group-term life insurance for any key employee is included in the gross income of the employee.

The cost of an employee's share of group-term life insurance generally is determined on the basis of uniform premiums, computed with respect to 5-year age brackets. In the case of a discriminatory plan, however, the amount included in income will be measured by the actual cost rather than the table cost prescribed by the Treasury.

Impact

These insurance plans, in effect, provide additional income to employees. Because the full value of the insurance coverage is not taxable, this income can be provided at less cost to the employer than the gross amount of taxable wages that would have to be paid to an employee to purchase an equal amount of insurance. Group-term life insurance is a significant portion of total life insurance. However, since neither the value of the insurance coverage nor the life insurance proceeds are included in gross income, the value of this fringe benefit is never subject to income tax.

Individuals who are self-employed or who work for an employer without such a plan do not have the advantage of this tax subsidy for life insurance protection.

Rationale

This exclusion was originally allowed, without limitation as to coverage, by administrative legal opinion (L.O. 1014, 2 C.B. 8 (1920)). The reason for the ruling is unclear, but it may have related to supposed difficulties in valuing the insurance to individual employees since the value is closely related to age and other mortality factors. Studies later indicated valuation was not a problem. The $50,000 limit on the amount subject to exclusion was enacted in 1964. Reports accompanying that legislation reasoned that the exclusion would encourage the purchase of group life insurance and assist in keeping the family unit intact upon death of the breadwinner.

The further limitation on the exclusion available for key employees in discriminatory plans was enacted in 1982 and expanded in 1984 to apply to post-retirement life insurance coverage.

Selected Bibliography

Clarke, Robert W. and J. Finley Lee. "Employee Life Insurance Benefits: The Inequity of Section 79." Insurance Law Journal, No. 587, Dec. 1971: 641–644.

Employee Benefit Research Institute. *Fundamentals of Employee Benefit Programs.* 2d ed. Washington, D.C.: Employee Benefit Research Institute, 1985: 175–179.

Hanlon, Paul P. "Qualifying Group-Term Life Insurance." Practical Lawyer, v. 24, Dec. 1, 1978: 35–41.

Nasuti, James F. "A Comparison of Life Insurance in Qualified Plans With Group-Term and Group-Permanent Life Insurance in Section 79 Plans." Insurance Law Journal, No. 677, June 1979: 328–334.

Salem, Irving and Richard L. Schmalbeck. "Group-Term Insurance: IRS Creates New Solutions, Questions and Challenges." Journal of Taxation, v. 51, Sept. 1979: 130–136.

U.S. Congress. House. Committee on Ways and Means. *Hearings on President's 1963 Tax Message.* 88th Cong., 1st sess., 1963: 108–113.

EXCLUSION OF OTHER EMPLOYEE BENEFITS

PREMIUMS ON ACCIDENT AND DISABILITY INSURANCE

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	0.1		0.1
1987	.1		.1
1988	.1		.1
1989	.1		.1
1990	.1		.1
1991	.2		.2

Authorization

Sections 105 and 106.

Description

Premiums paid by employers for employee accident and disability insurance plans are not included in the gross income of employees. Although benefit payments to employees generally are taxable, an exclusion is provided for payments related to permanent injuries and computed without regard to the period the employee is absent from work.

Impact

As with term life insurance, since the value of this insurance coverage is not taxable, the employer's cost is less than he would have to pay in wages that are taxable, to confer the same benefit on the employee. Employers thus are encouraged to buy such insurance for employees. Because some proceeds from accident and disability insurance plans, as well as the premiums paid by the employer, are not included in gross income, the value of the fringe benefit is never subject to income tax.

Rationale

This provision was enacted in 1954. Previously, only payments for plans contracted with insurance companies could be excluded from gross income. The committee report indicated this provision equalized the treatment of employer contributions regardless of the form of the plan.

Selected Bibliography

Guttentag, Joseph F., E. Deane Leaonard and William Y. Rodewald. "Federal Income Taxation of Fringe Benefits: A Specific Proposal." National Tax Journal, Sept. 1953: 250–272.

McDermott, William T. and George Bauernfeind. "Wage Continuation Plans Permit Employer to Deduct Tax Free Payments to Employee." Taxation for Accountants, v. 11, Sept. 1973: 138–143.

"Taxation of Employee Accident and Health Plans Before and Under the 1954 Code." Yale Law Journal, v. 64, No. 2, Dec. 1954: 222–247.

Wentz, Roy. "An Appraisal of Individual Income Tax Exclusions," in: U.S. Congress. House. Committee on Ways and Means. *Tax Revision Compendium.* Committee Print. 1959: 329–40.

ADDITIONAL EXEMPTION FOR THE BLIND

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	(1)		(1)
1987	(1)		(1)
1988	(1)		(1)
1989	(1)		(1)
1990	(1)		(1)
1991	(1)		(1)

(1) Less than $50 million.

Authorization

Section 151(d).

Description

Blind taxpayers receive a special personal exemption in addition to the normal personal exemption. The exemption amount in 1985 is $1,040 and will be adjusted for inflation in each future year. The extra exemption is not available for blind dependents.

Impact

The benefits accrue to taxpayers who are blind or have a blind spouse. Because of their disability, blind persons may incur extra expenses to live at a given standard, and the extra exemption helps compensate for this. The amount of tax relief per exemption increases from $114 to $520 as the marginal tax rate increases from 11 percent to 50 percent.

Rationale

Special tax treatment for the blind first appeared in 1943 when additional benefits were available through an itemized deduction. The law was amended in 1948 to offer relief as an exemption so that all blind taxpayers could claim the allowance.

Selected Bibliography

Groves, Harold M. *Federal Tax Treatment of the Family.* Washington, D.C.: The Brookings Institution, 1963: 54–55.

Lightman, Gary P. "Tax Expenditure Analysis of I.R.C. Sec. 151(d), the Additional Exemption for the Blind: Lack of Legislative Vision?" Temple Quarterly, v. 50, No. 4, 1977: 1086–1104.

U.S. President (1981- : Reagan). *The President's Tax Proposals to the Congress for Fairness, Growth and Simplicity.* Washington: GPO, 1985: 11–14.

ADDITIONAL EXEMPTION FOR THE ELDERLY

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	2.8		2.8
1987	3.3		3.3
1988	3.5		3.5
1989	3.7		3.7
1990	3.9		3.9
1991	4.2		4.2

Authorization

Section 151(c).

Description

An additional personal exemption is allowed for a taxpayer who is 65 or older. The exemption amount in 1985 is $1,040 and will be adjusted for inflation in each future year.

Impact

The amount of tax relief per exemption increases from $114 to $520 as the marginal tax rate increases from 11 to 50 percent. This provision offers no assistance to elderly persons who have no tax liability or are claimed as dependents on another taxpayer's return.

Rationale

The additional personal exemption originally was provided in the Revenue Act of 1948 to provide tax relief for the elderly whose income sources were reduced by old age.

Further Comment

The present additional exemption should be viewed within the context of the total transfer payment program currently in force, parts of which provide cash payments that are limited to needy elderly persons.

Chen, Yung-Ping. "Income Tax Exemption for the Aged as a Policy Instrument." National Tax Journal, v. 16, No. 4, Dec. 1963: 325–328.

Groves, Harold M. *Federal Tax Treatment of the Family*. Washington, D.C.: The Brookings Institution, 1963: 52–53.

Livsey, Herbert C. "Tax Benefits for the Elderly: A Need for Revision." Utah Law Review, v. 1969, No. 1, 1969: 84–117.

Tate, John. "Aid to the Elderly: What Role for the Income Tax?" University of Cincinnati Law Review, v. 41, No. 1, 1972: 93–115.

(600) Income Security

CREDIT FOR THE ELDERLY AND THE PERMANENTLY AND TOTALLY DISABLED

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	0.2	....	0.2
1987	.2	....	.2
1988	.2	....	.2
1989	.2	....	.2
1990	.2	....	.2
1991	.2	....	.2

Authorization

Section 22.

Description

Individuals who are 65 or more years old may claim a tax credit equal to 15 percent of a base amount. The credit is also available to an individual, regardless of age who is retired on disability and who when he retired was permanently and totally disabled. In computing the amount of the credit, a maximum base amount is provided by the Code and certain reductions are then made.

The maximum base amount in the case of a married couple filing jointly where both spouses are 65 or over is $7,500. In the case of a married couple filing jointly where one spouse is 65 or over and the other spouse is under 65 but permanently and totally disabled, the maximum base amount is the lesser of $7,500 or $5,000 plus "disability income" received by the spouse under 65. "Disability income" is gross income from amounts received as wages (or in lieu of wages) for the period during which the individual is out of work due to permanent and total disability. A maximum base amount of $5,000 is provided for a single taxpayer 65 or over and a married couple filing jointly where one spouse is 65 or over and the other spouse is under 65 and not permanently and totally disabled. In the case of a married couple filing jointly where both are under 65 and both are permanently and totally disabled, the maximum base amount is the lesser of $7,500 or the sum of the spouses "disability income." When a married couple files jointly and one is permanently and totally disabled but neither is 65 or over or in the case of a single individual under 65 but totally and permanently disabled, the maximum base amount is the lesser of $5,000 or the "disability income" received by the disabled person. The last two possibilities involve a married individual filing separately. If he is 65 or over, the maximum base amount is $3,750. If he is under 65 but permanently and totally disabled, the maximum base amount is the lesser of $3,750 or the "disability income" received.

The maximum base amount is then reduced by the sum of certain amounts received as pensions or annuities or as disability benefits which are excluded from gross income. This includes amounts payable under Title II of the Social Security Act, the Railroad Retirement Act of 1974, any law administered by the Veterans Administration or any other amounts excludible from gross income not listed above.

A further reduction from the maximum base amount is made by one-half of the excess over the following amounts: $7,500 adjusted gross income (AGI) in the case of a single individual, $10,000 in the case of a joint return, or $5,000 in the case of a married individual filing a separate return.

Example

A husband and wife are both 66 and file a joint return. He receives a taxable pension of $5,000, wages of $3,000, and a social security pension of $1,000. She receives a taxable pension of $2,000, wages of $1,000 and a social security pension of $400. They receive interest income of $200. The tax credit for the elderly and the permanently and totally disabled is computed as follows:

Maximum amount upon which credit may be based	$7,500
Less:	
Husband's social security pension	1,000
Wife's social security pension	400
One-half of AGI in excess of $10,000 (½ of $1,200)	600
Total	2,000
Amount of which tax credit is based	5,500
Amount of credit (15 percent of $5,500)	825

Impact

The maximum credit per individual is $750 (15 percent of $5,000) and $1,125 in the case of a married couple both 65 or over (15 percent of $7,500). Because the amount of eligible income is reduced by the amount of social security benefits received the primary beneficiaries of this credit are Federal retirees and those State and local government employees who do not receive social security benefits and, thus, do not benefit from the tax-exempt status of those benefits. For taxable years beginning after 1983, public system retirees under 65 no longer receive a 15-percent credit based on the amount of their pension or annuity from Federal, State, and local retirement systems. This change in the law was enacted to achieve more parity in the taxation of these various groups of taxpayers.

The adjusted gross income phaseout limits the tax relief largely to low- and middle-income taxpayers. In conjunction with the standard deduction and the additional personal exemption for persons 65 or older, the provision permits low income elderly persons who work to receive substantial amounts of income before becoming taxable. The credit, however, is not available to taxpayers under age 65 unless they are retired and when retired were permanently and totally disabled.

Because the provision is a credit, its value to the taxpayer is affected only by the level of benefits and the credit rate, and not by the tax bracket of the taxpayer.

Rationale

The retirement income credit originally enacted in 1954, was intended to remove inequities between individuals who received retirement income that was not tax exempt and who received social security payments which were tax exempt. The retirement income credit was applicable to retirement income only. In 1976, the tax credit for the elderly was enacted to: (1) update the maximum amount of income eligible for the credit, (2) eliminate the complexity of the retirement income credit, and (3) to allow individuals earning income as well as individuals with only retirement income to qualify for the credit. In the Social Security Amendments of 1983, the credit for the elderly and permanently and totally disabled was enacted to again provide greater equity between social security retirement recipients and nonsocial security retirees. Since social security payments are now taxable over a certain threshold, the disparity in tax treatment between the old tax-exempt social security payments and fully taxable nonsocial security retirement payments is lessened for taxpayers with incomes above these thresholds. The Congress believed that the tax treatment of an individual who is permanently and totally disabled and one who is age 65 or over should be equivalent in this regard. For this reason, the credit is available to permanently and totally disabled individuals regardless of age just as the tax treatment of social security benefits is equivalent for the aged and disabled.

Selected Bibliography

Livsey, Herbert C. "Tax Benefits for the Elderly: A Need for Revision." Utah Law Review, v. 1969, No. 1, Jan. 1969: 84–117.

Philbin, John A. and Jane Engel Gallacher. "Special Tax Provisions That Can Produce Income Tax Savings for the Older Client." Taxation for Accountants, v. 24, Mar. 1980: 136–139.

Talley, Louis Alan. *Proposed Revision of the Federal Income Tax Credit for the Elderly—Analysis of H.R. 8818 and S. 2128.* Washington, D.C.: The Library of Congress, Congressional Research Service, Aug. 31, 1978: 10p.

Tate, John. "Aid to the Elderly: What Role for the Income Tax?" University of Cincinnati Law Review, v. 41, No. 1, 1972: 93–115.

Terhune, Jean L. "Tax Credit for the 'Elderly' Is Not Restricted to Low-Income Taxpayers." Taxation for Accountants, v. 26, Feb. 1981: 96–99.

U.S. Congress. Joint Committee on Taxation. *General Explanation of the Tax Reform Act of 1976.* Dec. 29, 1976: 117–123.

U.S. President (1981- : Reagan). *The President's Tax Proposals to the Congress for Fairness, Growth and Simplicity.* Washington: GPO, 1985: 11–14.

DEDUCTIBILITY OF CASUALTY AND THEFT LOSSES

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	0.3		0.3
1987	.3		.3
1988	.3		.3
1989	.3		.3
1990	.4		.4
1991	.4		.4

Authorization

Section 165(c)(3).

Description

An individual may deduct the amount of personal casualty losses in excess of 10 percent of adjusted gross income that are sustained during a taxable year. Each casualty loss may be included in the amount of losses eligible for deduction to the extent the loss is greater than any insurance compensation or other gain plus $100. Casualty losses are defined as losses that arise from fire, storm, shipwreck, or other casualty, or theft.

Impact

This provision grants some financial assistance to those who suffer substantial casualties, have tax liability, and itemize deductions. It shifts part of the loss from the property owner to the general taxpayer, and thus serves as a form of insurance. The same dollar amount of loss has a proportionately greater effect on a low-income family than on a higher income family, yet the insurance feature of the deduction is greater for taxpayers in higher income tax brackets.

Rationale

The deduction for casualty losses was allowed under the original 1913 income tax law without distinction between business-related and non-business-related losses. No rationale was offered then. In

1964, the $100 floor on the deduction was enacted, and the purpose of relieving hardship was articulated in the legislative history.

TEFRA provided that the itemized deduction for nonbusiness casualty and theft losses would be allowed only to the extent losses exceeded 10 percent of the taxpayer's adjusted gross income.

Selected Bibliography

U.S. Congress. Joint Committee on Taxation. *General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982.* Committee Print. 97th Cong., 2d sess., Dec. 31, 1982: 26–27.

(600) Income Security

EARNED INCOME CREDIT

Estimated Revenue Loss [1]

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	0.4		0.4
1987	.3		.3
1988	.3		.3
1989	.3		.3
1990	.3		.3
1991	.3		.3

[1] The figures in the table show the effect of the earned income credit on receipts. The increase in outlays is $1.4 billion in FY 1986, $1.6 billion in FY 1987, $1.5 billion in FY 1988, $1.4 billion in FY 1989, $1.3 billion in FY 1990, and $1.2 billion in FY 1991.

Authorization

Section 32.

Description

The earned income tax credit is available to married couples filing joint returns who are entitled to a dependency exemption for a child, surviving spouses (who, by definition, must maintain a household for a dependent child), and heads of households who maintain a household for a child. The credit equals 11 percent of the first $5,000 of earnings, and thus may not exceed $550 per family. For each dollar of adjusted gross income (or, if higher, earned income) above $6,500, the maximum credit is reduced by 12 2/9 cents. Thus, between incomes of $5,000 and $6,500 the maximum credit of $550 is received, and the credit is not available to taxpayers with incomes of $11,000 or above.

The credit is subtracted from tax liability, if any. Unlike other tax credits, any amount of the earned income credit in excess of tax liability is paid in cash to the eligible taxpayer. If desired, the taxpayer may file an eligibility certificate with his employer in order to receive advance payments of the credit with his paycheck.

Impact

The earned income credit may be viewed as a partial offset to social security taxes on low-income workers. The combined employer-employee social security tax rate is 14.1 percent (7.05 percent paid by each party). Assuming the employee bears the burden of the employer's portion in the form of lower wages, the 11-percent credit offsets over 75 percent of the tax.

The credit may help to encourage low-income workers to obtain employment and, thus, reduce the demand for welfare and unemployment benefits. Because of the phaseout of eligibility for the credit between $6,500 and $11,000 of income, most of the benefits of the credit are received by persons in the lowest expanded gross income category, $0–$10,000.

Rationale

The earned income credit was first enacted in the Tax Reduction Act of 1975. Providing relief from social security taxes for low-income workers was one purpose. Another reason cited by the tax committees was to provide relief to low-income people for recent increases in food and fuel prices. Some opponents believe relief of this nature would be more efficiently administered as a reduction of social security tax payments made by low-income wage earners.

The credit was continued by the Revenue and Adjustment Act of 1975, extened and broadened by the Tax Reform Act of 1976, extended through 1978 by the Tax Reduction and Simplification Act of 1977 and expanded, simplified and made permanent in the Revenue Act of 1978. The Deficit Reduction Act of 1984 increased the amount of the credit and the income level at which it begins to be phased out, and added a rule preventing individuals with low earned incomes but substantial investment incomes from claiming the credit.

Selected Bibliography

Brittain, John A. "Social Security Taxes: Problems and Prospects for Reform Revisited." Tax Notes, v. 1, Feb. 8, 1976: 18–25.

Campbell, Colin D. and William L. Peirce. *The Earned Income Credit.* Washington, D.C.: American Enterprise Institute for Public Policy Research, 1980.

Hoffman, Wayne Lee. *The Earned Income Credit: Welfare Reform or Tax Relief? An Analysis of Alternative Proposals.* Washington, D.C.: The Urban Institute, Sept. 1978.

U.S. Congress. House. *Tax Reform Act of 1976.* Report. No. 94-1515, 94th Cong., 2nd sess., Sept. 13, 1976: 429–430.

———. Committee on Conference. *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984.* Conference Report to accompany H.R. 4170. Report No. 98-861, 98th Cong., 2d sess., June 23, 1984: 1254–1255.

———. Joint Committee on Taxation. *General Explanation of the Revenue Act of 1978.* Mar. 12, 1979: 50–55.

———. Senate. *Tax Reduction Act of 1975.* Report No. 94-136, 94th Cong., 1st sess., Mar. 17, 1975: 11, 32–35.

EXCLUSION FOR EMPLOYER-PROVIDED DEATH BENEFITS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	([1])		([1])
1987	0.1		0.1
1988	.1		.1
1989	.1		.1
1990	.1		.1
1991	.1		.1

[1] Less than $50 million.

Authorization

Section 101(b).

Description

The first $5,000 paid by or on behalf of an employer by reason of an employee's death generally is excluded from the income of the employee's beneficiaries or estate, if certain requirements are met. This income exclusion for employer-provided death benefits is also generally applied to the first $5,000 paid as a lump sum distribution or, under certain circumstances, as a joint and survivor annuity under a qualified pension, etc., plan.

Impact

This provision provides a limited exclusion for certain noninsured employer-provided death benefits. The value of the exclusion is greater for beneficiaries or estates in higher marginal tax brackets.

Rationale

The provision permitting a limited exclusion for noninsured employer-provided death benefits first was added by the Revenue Act of 1951. Reports accompanying that legislation note that the exclusion was needed to correct the hardship caused by taxing employer-provided benefits, while the $5,000 limitation was needed to prevent abuse.

U.S. President (1981- : Reagan) *The President's Tax Proposals to the Congress for Fairness, Growth and Simplicity.* Washington: GPO, 1985: 30-31.

(600) Income Security

EXCLUSION OF INCOME EARNED BY CERTAIN BENEFIT ORGANIZATIONS

Estimated Revenue Loss

Supplemental Unemployment Benefit Trusts

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	[1]		[1]
1987	[1]		[1]
1988	[1]		[1]
1989	[1]		[1]
1990	[1]		[1]
1991	[1]		[1]

[1] Less than $50 million.

VARIABLE EMPLOYEE BENEFIT ASSOCIATION

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	0.4		0.4
1987	.4		.4
1988	.4		.4
1989	.5		.5
1990	.5		.5
1991	.5		.5

Authorization

Sections 404, 419, 419A, 501(c)(17), 501(c)(19), 505, 512, and 4976.

Description

Supplementary unemployment benefit (SUB) trusts.—Investment income earned by a trust established by an employer to fund payment of supplemental unemployment compensation benefits to employees generally is exempt from Federal income tax. The benefits payable out of a tax-exempt SUB trust are (1) benefits that are paid to an employee because of involuntary separation from employment with the employer (whether or not temporary) resulting directly from a reduction in force, the discontinuance of a plant or operation, or other similar conditions, and (2) sick and accident benefits that are subordinate to the supplemental unemployment benefits. Beginning in 1986, new rules adopted in the Tax Reform Act of 1984 will govern an employer's deduction for contributions to a SUB trust.

Variable Employee Benefit Association (VEBA).—A deduction is allowed for employer contributions to a fund that provides welfare benefits to employees (for example, a fund providing medical benefits). The employer's deduction for a year consists of (1) the cost of benefits provided during the year from employer contributions, and (2) an addition to a reserve to provide benefits in the future. The deduction for reserve additions is generally limited to unpaid claims incurred to provide insurance-type benefits (health and accident, life, and disability), severance pay benefits, and supplemental unemployment compensation. No deduction is allowed for a reserve addition to provide a benefit that discriminates in favor certain owners or highly compensated employees. Investment income set aside to provide permitted benefits under a welfare benefit fund is generally exempt from tax. Limits are provided on the amount that is considered set aside for these purposes. Employer deductions for welfare benefits under an unfunded plan are allowed when benefits are provided.

Impact

In general, the year in which an employer may deduct compensation provided to its employees, either in the form of cash or welfare benefits, corresponds to the year in which the employees include the compensation in income. In addition, if an employer prefunds its obligations to pay future employee compensation, income earned on the amounts set aside for that purpose is taxable to the employer.

In the case of SUB trusts and VEBA's, however, employers are granted more favorable treatment for amounts set aside to prefund future obligations to provide compensation in the form of welfare benefits. In these cases, the employer is allowed a current deduction for contributions to a reserve for future compensation, and the reserve is permitted to grow on a tax-exempt basis. At the same time, SUB trusts and VEBA's—unlike qualified pension plans—are not subject to minimum standards for funding, participation and benefits accrual, or to annual limits on benefits. (Although rules adopted in the Tax Reform Act of 1984 will limit the type and levels of benefits for which an employer may prefund a SUB trust on a tax-favored basis, the advantage of tax-exempt growth remains for certain benefits within the specified limits.) It is argued that the tax exemption for investment income of SUB trust and VEBA's effectively shifts a portion of the cost of employee compensation to the general public.

Rationale

The income tax exemptions for SUB trusts and VEBA's benefit employees who will receive supplemental unemployment or black lung payments by reducing the cost to the employer of prefunding such obligations.

Selected Bibliography

Commerce Clearing House. *VEBAs Explained.* Pension Plan Guide No. 514. Chicago, Ill.: Commerce Clearing House, Inc., Feb. 1, 1985.

Gilman, Barry M. "The Effect of the Tax Reform Act of 1984 on VEBAs." Employee Benefits Journal, v. 9, Dec. 1984: 23–26.

(700) Veterans Benefits and Services

VETERANS BENEFITS AND SERVICES

(1) EXCLUSION OF VETERANS DISABILITY COMPENSATION

(2) EXCLUSION OF VETERANS PENSIONS

(3) EXCLUSION OF GI BILL BENEFITS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals			Total
	Veterans disability compensation	Veterans pensions	GI bill benefits	
1986..	1.7	0.2	0.1	2.0
1987..	1.8	.2	.1	2.1
1988..	1.8	.2	.1	2.1
1989..	1.9	.2	.1	2.2
1990..	1.9	.2	.1	2.2
1991..	1.9	.2	.1	2.2

Authorization

38 U.S.C. 3101.

Description

All benefits administered by the Veterans Administration are exempt from income tax. These include veterans disability compensation, veterans pension payments, and education payments.

Impact

Veterans service-connected disability compensation payments are related not to income levels, but to the degree of impairment resulting from the various injuries.

The pensions paid to qualifying nonservice disabled and aged veterans are based on countable income. The attainment of age 65 is considered a de facto disability. The larger a veteran's countable income is, the smaller the veteran's pension will be. For veterans commencing benefits after December 31, 1978, countable income includes earnings of the veteran, spouse, and dependent children, if any. Veterans who commence benefits on or before that date could elect to continue under prior law, which excluded from countable income the income of a spouse, among other items. Therefore, veterans still covered by prior law could receive the same pension—based on the same amount of countable income—but have quite different amounts of total income when the excluded items were taken into account.

Veterans education benefits vary with the number of dependents and type of training.

The benefit of the exclusion of veterans benefits increases with the marginal tax brackets of the recipients.

Rationale

Since 1917, veterans benefits have been exempt from income tax. The original rationale for the exemption is not clear.

Further Comment

One general issue concerning these benefit programs which has been the subject of discussion is whether net (after-tax) benefit differentials should depend on the tax bracket of the recipient. Increases in the amount of direct payments under the programs are alternatives to the current exemption.

Selected Bibliography

U.S. Congress. Congressional Budget Office. *Disability Compensation: Current Issues and Options for Change.* 97th Cong., 2d sess., June 1982.

EXCLUSION OF INTEREST ON STATE AND LOCAL VETERANS HOUSING BONDS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	NA	NA	NA
1987	0.3	0.1	0.4
1988	.3	.1	.4
1989	.3	.1	.4
1990	.3	.1	.4
1991	.3	.1	.4

Authorization

Section 103A of the Internal Revenue Code of 1954, as most recently amended by Title VI of Public Law 98-369 (Deficit Reduction Act of 1984).

Description

The interest on bonds issued by State and local governments to provide mortgages for veterans housing is exempt from Federal tax. This exemption applies without regard to most of the limitations (including sunset rules) applicable to nonveterans mortgage bonds. However, to qualify under this provision, the bonds must be general obligation bonds.

The Deficit Reduction Act of 1984 included rules designed to limit the veterans bond program to States which issued such bonds prior to 1984, in the average amounts in which such bonds were previously issued. The act also limited the program to veterans who served before 1977, and specified that only principal residences may be financed by the bonds.

As in the case of nonveterans housing bonds, the issuer of veterans mortgage bonds typically uses bond proceeds to purchase mortgages made by a private lender. The homeowners make their monthly payments to the private lender, which passes them through as payments to the bondholders.

Impact

Tax-exempt housing bonds subsidize private housing. Since interest on the bonds is tax exempt investors are willing to accept lower before-tax rates of interest than on taxable securities. Consequently, by financing housing through these bonds, the issuer can offer reduced mortgage interest rates.

Benefits of the tax exemption are conferred on both the bondholders and the homeowners who get their mortgages from them. The allocation of benefits between the bondholders and the homeowners depends on the spread in interest rates between the tax-exempt and taxable bond market. The smaller the spread, the larger the proportion of benefits accruing to the bondholders.

Tax-exempt bonds issued for veterans housing totaled $0.7 billion in 1982 and $0.9 billion in 1983.

Rationale

Five States (California, Oregon, Wisconsin, Alaska, and Texas) have issued tax-exempt bonds for veterans housing, the first beginning just after World War II.

When Congress limited the volume of nonveterans mortgage bonds in 1980, it allowed general obligation veterans bonds to continue to be issued outside of these limitations. The 1984 volume limitations on veterans mortgage bonds took place in the context of an extension of the nonveterans bond program; essentially, these changes amounted to repeal of the special status of veterans mortgage bonds with a grandfathering of the existing veterans programs.

Selected Bibliography

U.S. Congress. Joint Committee on Taxation. *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984.* Committee Print. 98th Cong., 2d sess., Dec. 31, 1984: 903–958.

CREDITS FOR POLITICAL CONTRIBUTIONS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	0.3		0.3
1987	.2		.2
1988	.3		.3
1989	.3		.3
1990	.3		.3
1991	.3		.3

Authorization

Section 24.

Description

Individual, but not corporate, taxpayers are allowed a tax credit equal to one-half of their political contributions to candidates for Federal, State, or local elective office and to national political parties. The credit cannot exceed $50 for a single individual or $100 for a married couple filing a joint return.

Impact

The credit allows a taxpayer to reduce the cost of a limited amount of political contributions by 50 percent. Thus, for each $2 of contributions—up to a limit of $100 per taxpayer—the Federal Government returns a dollar to the taxpayer through lower tax liability, in effect matching the taxpayer's contribution. Because of the dollar limitations, this provision is not of great significance to large contributors.

Rationale

The credit for political contributions was adopted with one-fourth the current limit as part of the Revenue Act of 1971; the maximum amount was increased in 1974 and 1978. The purpose of enacting the credit was to encourage more widespread financing of political campaigns through small contributions.

Selected Bibliography

Burdette, Robert. *Federal Tax Law of Special Interest to Participants in Political Campaigns.* Multilith No. 81-192A. Washington, D.C.: The Library of Congress, Congressional Research Service, June 2, 1975, updated Aug. 5, 1981.

U.S. Congress. Joint Committee on Internal Revenue Taxation. *General Explanation of the Revenue Act of 1971.* Dec. 15, 1972: 127–128.

———. Joint Committee on Taxation. *General Explanation of the Revenue Act of 1978.* Mar. 12, 1979: 61–62.

U.S. Department of the Treasury. *The President's 1978 Tax Program: Detailed Descriptions and Supporting Analyses of the Proposals.* Jan. 30, 1978: 55–58.

(850) General Purpose Fiscal Assistance

EXCLUSION OF INTEREST ON GENERAL PURPOSE STATE AND LOCAL DEBT

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	NA	NA	NA
1987	9.4	2.4	11.8
1988	10.2	2.6	12.8
1989	11.0	2.8	13.8
1990	11.9	3.0	14.9
1991	13.0	3.3	16.3

Authorization

Section 103 of the Internal Revenue Code of 1954, as most recently modified by Title VI of Public Law 98–369 (Deficit Reduction Act of 1984).

Description

In general, interest on the obligations of State and local governments is excludable from gross income.[1]

Impact

Because the interest is exempt from tax, the interest rate on State and local government obligations is lower than the rate on comparable taxable bonds. In effect, the Federal Government subsidizes States and localities by paying part of their interest cost. For example, if the market rate on tax-exempt bonds is 8 percent when the taxable rate is 10 percent, there is a 2-percentage point subsidy to State and local governments (assuming a 50-percent marginal tax rate). The remaining 2 points of subsidy flow to the tax-exempt bond investor in the increased after-tax return of the investment.

Tax-exempt bonds are viewed by some persons as a particularly attractive form of indirect Federal aid because they operate automatically without Federal regulations.

---

[1] Various bonds for special purposes (e.g., industrial development bonds and pollution control bonds) are discussed specifically, and in greater detail, under the appropriate tax expenditure areas.

Commercial banks, fire and casualty insurance companies, and high-income individuals are the major buyers of tax-exempt bonds. Tax-exempt institutions, such as pension funds, have no incentive to invest in tax-free bonds since the return is much lower than that of taxable securities. Therefore, the tax-exempt nature of State and local debt, in effect, restricts the potential market for these securities to taxable individuals and organizations.

States and localities have traditionally issued tax-exempt bonds to finance public projects, such as schools, roads, sewers, transportation facilities, and government buildings. Bonds issued for these purposes are usually general obligations of the State or local government. In recent years, States and localities also have been issuing increasing volumes of tax-exempt revenue bonds to provide low-cost financing for quasi-public and private facilities. Revenue bonds now account for approximately 70 percent of all new long-term tax-exempt issues. The growing use of tax-exempt bonds for privately owned facilities has caused tax-exempt interest rates to rise more rapidly than conventional interest rates over the past decade. As a result, the savings usually realized from tax exemption have decreased, and municipalities are paying relatively higher costs to finance public projects.

The Deficit Reduction Act of 1984 denied a tax exemption for federally guaranteed State and local bonds, and made various other changes in the laws affecting such bonds; however, bonds for traditional governmental purposes were not included in the volume limitations imposed by the 1984 Act. One reason given for limiting private activity bonds was to prevent the proliferation of these bonds from driving up interest rates on bonds for traditional public purposes.

Rationale

This exemption has been in the income tax laws since 1918, and apparently was based on the belief that the Federal Government could not constitutionally tax such interest. Today, the exemption is justified on other grounds, principally as a means of assisting State and local governments with a minimum of Federal interference.

Selected Bibliography

American Bar Association. Selection of Local Government Law. Committee on Taxation of State and Local Obligations. "Taxation of State and Local Obligations. Urban Lawyer, v. 9, fall 1977: 919–932.

Bagwell, Marvin N., Michael W. Evans, and Mark F. Nielsen. "The Municipal Bond Market: An Analysis and Suggested Reform." Harvard Journal on Legislation, v. 16, Dec. 1979: 211–267.

Craig, Eleanor D. "The Impact of Federal Policies on Municipal Bond Financing." National Tax Journal, v. 34, No. 3, Sept. 1981: 389–394.

Forbes, Ronald W. and John E. Petersen. "Background Paper," in: *Building a Broader Market: Report of the Twentieth Century Fund Task Force on the Municipal Bond Market.* New York: McGraw-Hill, 1976: 27–174.

Fortune, Peter. "Tax Exemption of State and Local Interest Payments: An Economic Analysis of the Issues and an Alternative." New England Economic Review, May/June 1973: 3-31.

Galper, Harvey and George Peterson. "Analysis of Subsidy Plans to Support State and Local Borrowing." National Tax Journal, v. 24, June 1971: 205-234.

———. "The Equity Effects of a Taxable Municipal Subsidy." National Tax Journal, v. 26, Dec. 1973: 611-624.

Goode, Richard. *The Individual Income Tax*. Rev. ed. Washington, D.C.: The Brookings Institution, 1976: 133-138.

Huefner, Robert P. *Taxable Alternative Municipal Bonds*. Research Report No. 53. Boston, Mass.: Federal Reserve Bank of Boston, 1973.

Molchan, Thomas M. "Reform of the Municipal Bond Market: Alternatives to Tax-Exempt Financing." Columbia Journal of Law and Social Problems, v. 15, No. 3, 1980: 233-275.

Mussa, Michael L. and Roger C. Kormendi. *The Taxation of Municipal Bonds: An Economic Appraisal*. Washington, D.C.: American Enterprise Institute, 1979.

Ott, David J. and Allan H. Meltzer. *Federal Tax Treatment of State and Local Securities*. Washington, D.C.: The Brookings Institution, 1963.

Ott, David J. and Attiat F. Ott. "The Tax Subsidy Through Exemption of State and Local Bond Interest," in: U.S. Congress. Joint Economic Committee. *The Economics of Federal Subsidy Programs*. Part 3—"Tax Subsidies." 92d Cong., 2d sess., July 15, 1972: 305-316.

Patterson, Grady L., Jr. *A Case Against Tampering With Tax Exemption*. Special Bulletin 1975A. Washington, D.C.: Municipal Finance Officers Association, Jan. 1, 1975.

Pechman, Joseph A. *Federal Tax Policy*. Fourth edition. Washington, D.C.: The Brookings Institution, 1983: 117-121.

Shaul, Marnie. "The Taxable Bond Option for Municipal Bonds." Columbus, Ohio: Academy for Contemporary Problems, 1977.

Surrey, Stanley S. *Pathways to Tax Reform*. Cambridge, Mass.: Harvard University Press, 1973: 210-222.

———. "Three Arguments for the Taxable Bond Option: Equity, Efficiency, and Marketability." Tax Notes, Mar. 29, 1976: 9-13.

U.S. Congress. Congressional Budget Office. *The Tax Exemption on State and Local Bonds*. Report to the House Budget Committee, Nov. 18, 1975.

———. Joint Committee on Internal Revenue Taxation. *Taxable Bond Alternative for State and Local Governments*. Mar. 29, 1976.

U.S. Department of the Treasury. *The President's 1978 Tax Program: Detailed Descriptions and Supporting Analyses of the Proposals*. Chapter IIIA—"State and Local Taxable Bond Option." Jan. 30, 1978: 215-235.

(850) General Purpose Fiscal Assistance

DEDUCTIBILITY OF NON-BUSINESS STATE AND LOCAL TAXES (OTHER THAN ON OWNER-OCCUPIED HOMES)

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	NA		NA
1987	22.7		22.7
1988	25.1		25.1
1989	27.7		27.7
1990	30.6		30.6
1991	33.8		33.8

Authorization

Section 164.

Description

An individual may claim State and local income, personal property, and general sales taxes not incurred in business or investment activities as itemized deductions. (A deduction is also allowed for foreign real property and income taxes.) See description under function 370 for deductibility of property taxes on owner-occupied homes.

Impact

This deduction for State and local tax payments benefits only taxpayers who itemize their deductions. They are concentrated in the middle and higher income brackets, largely among persons who own homes, because these are the taxpayers who generally itemize.

The Federal tax deduction for State and local sales taxes and miscellaneous taxes accentuates the generally regressive nature of the nonincome taxes because the amount of tax benefit per dollar of deduction increases with the tax bracket of the taxpayer. State and local income taxes generally are progressive, but the Federal deduction lessens the effect of their progressivity.

Rationale

The allowance of a deduction for general State and local government taxes has always been a part of the Federal income tax structure. Although the legislative history is not explicit, it suggests that general State and local government taxes have been viewed as reducing an individual's ability to pay Federal income tax. Some now regard this treatment as a form of revenue sharing.

A deduction for the Federal income tax was eliminated in 1917, and the deduction for Federal excise taxes was eliminated in 1943. The deduction for State and local taxes on tobacco and alcoholic beverages was eliminated in 1964, along with automobile and drivers' licenses and other State and local selective excise taxes except gasoline taxes. Further, the deduction for State and local taxes on gasoline and other motor fuels for nonbusiness use was eliminated after 1978. By allowing State and local income, personal property, and general sales tax payments to be deducted as are real property taxes, the Federal Government avoids unequal treatment of taxpayers whose State and local governments have chosen different mixes of general taxes.

Selected Bibliography

Due, John F. "Personal Deductions," in: Joseph A. Pechman, ed. *Comprehensive Income Taxation.* Washington, D.C.: The Brookings Institution, 1977: 50-52.

Kahn, C. Harry. *Personal Deductions in the Federal Income Tax.* Princeton, N.J.: Princeton University Press for the National Bureau of Economic Research, 1960: 92-108.

Kenyon, Daphne. "Federal Income Tax Deductibility of State and Local Taxes: What Are Its Effects? Should It Be Modified or Eliminated?" in: *Strengthening the Federal Revenue System.* Advisory Commission on Intergovernmental Relations. Report A-97, 1984: 37-66.

Moscovitch, Edward. "State Graduated Incomes Taxes—A State-Initiated Form of Federal Revenue Sharing." National Tax Journal, v. 25, Mar. 1972: 53-64.

Noto, Nonna A. and Dennis Zimmerman. "Limiting State-Local Deductibility: Effects Among the States." National Tax Journal, v. 37, Dec. 1984: 539-549.

U.S. Congress. Joint Committee on Taxation. *General Explanation of the Revenue Act of 1978,* Mar. 12, 1979: 56-57.

———. Senate. Committee on Governmental Affairs. *Limiting State-Local Tax Deductibility in Exchange for Increased General Revenue Sharing: An Analysis of the Economic Effects.* Committee Print. 98th Cong., 1st sess., 1983.

U.S. Department of the Treasury. *Blueprints for Basic Tax Reform.* Washington, D.C., Jan. 17, 1977: 92-94.

———. *The President's 1978 Tax Program: Detailed Descriptions and Supporting Analyses of the Proposals,* Chapter II, B-3—"Deductions for State and Local Taxes." Jan. 30, 1978: 51-54.

(850) General Purpose Fiscal Assistance

TAX CREDIT FOR CORPORATIONS RECEIVING INCOME FROM DOING BUSINESS IN U.S. POSSESSIONS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986		1.6	1.6
1987		2.0	2.0
1988		2.2	2.2
1989		2.4	2.4
1990		2.7	2.7
1991		2.9	2.9

Authorization

Sections 934(b) and 936.

Description

A qualifying domestic corporation may elect not to pay tax on certain income earned in U.S. possessions. A corporation qualifies if, for the 3-year period preceding the end of the tax year, at least 80 percent of its gross income has been from sources within a possession, and at least 65 percent of its gross income is from the active conduct of a trade or business within a possession. Generally, this exemption is accomplished by granting a credit equal to the tax which otherwise would be paid on income earned within a possession. Full deductions are provided for dividends received by parent corporations from subsidiaries that elect the possessions credit.

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) made two changes designed to reduce the revenue cost due to (1) the inappropriate allocation of intangible income to possessions in order to claim exemption for such income, and (2) the exemption of passive income. The problem of intangible income was addressed by adding a complex set of allocation rules to section 936 for tax years beginning after 1982. These rules seek to limit the distortion of income that results when a U.S. taxpayer obtains tax benefits for research activities and a possessions corporation realizes tax-free income from the fruits of that research. The revenue cost of exempting passive income was addressed by increasing the active trade or business percentage from 50 percent in 1982 to 65 percent by 1985.

Impact

Corporations operating in Puerto Rico account for over 99 percent of the estimated revenue loss from this tax expenditure.

Puerto Rico grants substantial exemptions from income tax to encourage corporations to engage in manufacturing operations in the Commonwealth. Most possessions corporations are subsidiaries of U.S. corporations with U.S. (and sometimes foreign) operations. The combination of the possessions credit and Puerto Rican tax holidays results in little or no income tax being paid to any taxing authority. Puerto Rico has claimed that granting these incentives to U.S. firms is a vital part of the continued growth and development of the Puerto Rican economy, and its incentive acts have been drafted with U.S. laws in mind.

The Treasury has estimated that in 1980, 47 percent of the tax expenditure benefits from the possessions corporation exclusion went to pharmaceutical companies. Other types of businesses making substantial use of the exclusion were electrical and electronic equipment manufacturers. The Treasury report further indicates that 32 companies received roughly 48 percent of the total benefits derived from the possessions corporation rules in 1980.

Data concerning the impact of the 1982 legislation on tax liabilities is not yet available.

Rationale

Congress first exempted income of possessions corporations from tax in 1921. The purpose of this exemption was to promote the competitiveness of U.S. businesses operating in the possessions. Proponents of tax benefits for operations in the possessions contend that these benefits are necessary to encourage employment and economic growth in the possessions.

Selected Bibliography

Griggs, Robert S. "The Puerto Rico Industrial Incentives Act of 1978." International Tax Journal, v. 5, Apr. 1979: 273–298.

Hoff, Karla. "U.S. Federal Tax Policy Towards the Territories: Past, Present, and Future." Tax Law Review, v. 37, fall 1981: 51–102.

Kaufman, Nancy H. "Puerto Rico's Possessions Corporations: Do the TEFRA Amendments Go Too Far?" Wisconsin Law Review, No. 2, 1984: 531–566.

Kiefer, Donald W. *Treating Puerto Rico as a State Under Federal Tax and Expenditure Programs: A Preliminary Economic Analysis.* Multilith No. 77-202E. Washington, D.C.: The Library of Congress, Congressional Research Service, Sept. 7, 1977.

Madera, Jose R. *The Economic Development Administration Report of the Benefits of Section 936, U.S. Internal Revenue Code to Puerto Rico, U.S.A.* Hato Rey, Puerto Rico: Puerto Rico, U.S.A., 1984.

U.S. Congress. Joint Committee on Taxation. *General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982.* Committee Print. 97th Cong., 2d sess., Dec. 31, 1984: 79–96.

———. *General Explanation of the Tax Reform Act of 1976.* Committee Print. 94th Cong., 2d sess., Dec. 29, 1976: 272–278.

U.S. Department of Commerce. *Economic Study of Puerto Rico,* v. II. Washington, D.C.: U.S. Government Printing Office, 1979.

U.S. Department of the Treasury. *The Operation and Effect of the Possessions Corporation System of Taxation: Fourth Annual Report,* Feb. 1983.

———. *Territorial Income Tax Systems: Income Taxation in the Virgin Islands, Guam, the Northern Mariana Islands and American Samoa,* Oct. 1979.

U.S. General Accounting Office. *Puerto Rico's Political Future: A Divisive Issue With Many Dimensions.* Report to the Congress by the Comptroller General of the United States, GGD–81–48, Mar. 2, 1981: 73–77.

(900) Interest

DEFERRAL OF INTEREST ON SAVINGS BONDS

Estimated Revenue Loss

[In billions of dollars]

Fiscal year	Individuals	Corporations	Total
1986	0.7		0.7
1987	.7		.7
1988	.7		.7
1989	.8		.8
1990	.8		.8
1991	.8		.8

Authorization

Section 454.

Description

The Federal Government now issues Series EE savings bonds which receive a market-based interest rate that is 85 percent of the average yield on outstanding 5-year Treasury marketable securities for the entire period the bond is held, as long as the bond is held for at least 5 years. The minimum guaranteed rate on these bonds is 7.5 percent. The interest income on the bonds may be allowed to accrue throughout the period and may be excluded from taxable income until the bond is redeemed.

Impact

The deferral of tax on interest income resulting from owning savings bonds provides two advantages. First, payment of tax on the interest is deferred, amounting to an interest-free loan. Second, if bonds are purchased for retirement purposes, the taxpayer often is in a lower income bracket when the bonds are redeemed.

Rationale

Prior to 1951, a cash-basis taxpayer generally reported interest on U.S. Treasury original issue discount bonds in the year of redemption or maturity, whichever came first. In 1951, when provision was made to extend Series E bonds past their dates of original maturity, a provision was enacted to allow the taxpayer either to report the interest currently, or at the date of redemption, or upon final maturity. The committee reports indicated that the provision was adopted to facilitate the extension of maturity dates.

In 1959 a provision was added to allow taxpayers to convert Series E bonds to Series H bonds without paying tax on the accrued interest. The purpose was to encourage the holding of U.S. bonds.

Selected Bibliography

Keller, David. "Government Bonds Offer Unique Tax Deferral and Post-Mortem Estate Planning Possibilities." Taxation for Accountants, v. 24, Jan. 1980: 4-7.

Putnam, Jack H., Jr. "Taxation of United States Savings Bonds: Series E." American Bar Association Journal, Aug. 1976: 1039-1042.

Snyder, John W., Secretary of the Treasury. "Financial Mobilization." Address before the New York Board of Trade, Jan. 19, 1951. Reprinted in: U.S. Congress. House. Committee on Ways and Means. "Revenue Revision of 1951." Hearings. 82d Cong., 1st sess., 1951: 44-49.

U.S. Department of the Treasury. *Fifty Questions and Answers on U.S. Savings Bonds.* U.S. Savings Bonds Division. Washington, D.C., 1985. 12 p.

———. *United States Savings Bonds Program.* Study prepared for the Committee on Ways and Means, U.S. House of Representatives, 1981.

Appendix A

Distribution of Selected Individual Tax Expenditure Items by Expanded Income Class, at 1987 Rates and 1987 Income Levels

[Amounts in millions of dollars, returns in thousands]

Expanded income class (thousands)[1]	Age exemption		Blind exemption		Dividend exclusion	
	Returns	Amount	Returns	Amount	Returns	Amount
Below $10	390	50	21	4	557	6
$10 to $2	2,483	442	15	2	1,775	26
$20 to $30	3,074	780	45	9	3,494	74
$30 to $40	1,942	630	25	5	3,515	99
$40 to $50	905	388	46	11	2,850	102
$50 to $75	872	495	20	5	3,569	172
$75 to $100	298	214	6	2	1,138	69
$100 to $200	325	254	6	3	1,182	86
$200 and over	128	111	2	1	440	37
Total	**10,417**	**3,364**	**186**	**44**	**18,515**	**672**

	Medical deduction		Real estate tax deduction	
	Returns	Amount	Returns	Amount
Below $10	205	36	160	11
$10 to $20	1,752	312	2,440	228
$20 to $30	3,252	661	7,058	890
$30 to $40	2,817	751	8,780	1,564
$40 to $50	1,392	568	6,639	1,586
$50 to $75	1,069	466	6,417	2,450
$75 to $100	200	270	1,567	1,013
$100 to $200	169	345	1,431	1,438
$200 and over	33	242	465	845
Total	**10,890**	**3,652**	**34,958**	**10,025**

Footnotes at end of table.

Distribution of Selected Individual Tax Expenditure Items by Expanded Income Class, at 1985 Rates and 1983 Income Levels—Continued

Expanded income class (thousands)[1]	State and local income tax deduction		State and local sales tax deduction		House mortgage interest deduction	
	Returns	Amount	Returns	Amount	Returns	Amount
Below $10	258	7	334	7	236	44
$10 to $20	2,692	194	3,175	107	2,688	943
$20 to $30	7,439	1,055	8,372	441	6,914	3,612
$30 to $40	8,743	2,139	9,838	740	8,197	5,977
$40 to $50	6,392	2,469	7,127	764	5,956	5,923
$50 to $75	5,833	4,026	6,743	1,065	5,523	8,426
$75 to $100	1,435	1,896	1,615	408	1,310	3,443
$100 to $200	1,315	3,548	1,493	542	1,164	3,977
$200 and over	425	4,751	482	291	383	2,076
Total	**34,531**	**20,085**	**39,179**	**4,363**	**32,370**	**34,412**

	Deductibility of nonmortgage interest in excess of investment income		Charitable contributions deduction[2]		Casualty loss deduction	
	Returns	Amount	Returns	Amount	Returns	Amount
Below $10	167	15	230	5	34	2
$10 to $20	2,199	281	2,620	141	86	44
$20 to $30	5,900	1,139	7,748	670	82	124
$30 to $40	6,584	1,854	9,515	1,228	39	57
$40 to $50	4,660	1,661	6,942	1,281	22	22
$50 to $75	3,575	2,222	6,761	2,250	7	25
$75 to $100	641	822	1,681	956	3	9
$100 to $200	462	1,136	1,651	2,116	3	12
$200 and over	142	916	616	4,334	1	4
Total	**24,331**	**10,004**	**37,765**	**12,982**	**277**	**298**

Footnotes at end of table.

Distribution of Selected Individual Tax Expenditure Items by Expanded Income Class, at 1985 Rates and 1983 Income levels—Continued

Expanded income class (thousands) [1]	Child care credit		Earned income credit [2]	
	Returns	Amount	Returns	Amount
Below $10	138	43	4,479	1,684
$10 to $20	841	448	936	121
$20 to $30	1,539	661	0	0
$30 to $40	1,650	703	0	0
$40 to $50	1,248	486	0	0
$50 to $75	839	345	0	0
$75 to $100	120	50	0	0
$100 to $200	85	32	0	0
$200 and over	15	6	0	0
Total	**6,474**	**2,775**	**5,415**	**1,805**

	Political contribution credit		Capital gains exclusion	
	Returns	Amount	Returns	Amount
Below $10	291	10	219	36
$10 to $20	835	41	641	102
$20 to $30	773	38	1,163	327
$30 to $40	985	58	1,383	600
$40 to $50	736	41	1,049	780
$50 to $75	846	52	1,661	2,239
$75 to $100	283	17	605	1,648
$100 to $200	260	17	792	5,219
$200 and over	126	10	374	27,594
Total	**5,135**	**284**	**7,887**	**38,444**

*Less than $500,000 or 500 returns.

[1] Expanded income equals adjusted gross income plus minimum tax preferences (mostly excluded capital gains) less investment interest expense to the extent of investment income.

[2] This distribution is subject to substantially higher sampling variability than most of the others.

[3] Includes the refundable portion of the earned income credit.

NOTE: Detail may not add to total due to rounding.

Distribution by Expanded Income Class of All Returns, Taxable Returns, Itemized Returns, and Tax Liability, At 1985 Law and 1983 Income Levels [1]

[Money amounts in millions of dollars, returns in thousands]

Expanded income class (thousands) [2]	All returns	Taxable returns	Itemized returns		Tax liability [3]
			Total	Taxable	
Below $10	41,781	10,052	952	477	2,057
$10 to $20	26,621	20,772	4,381	3,260	22,319
$20 to $30	23,036	21,435	9,461	8,858	47,292
$30 to $40	16,107	15,642	10,430	10,217	50,967
$40 to $50	9,468	9,344	7,438	7,367	45,513
$50 to $75	7,870	7,778	7,011	6,940	60,470
$75 to $100	1,877	1,853	1,753	1,732	25,185
$100 to $200	1,787	1,759	1,707	1,679	47,875
$200 and over	662	651	646	634	86,089
Total	**129,210**	**89,287**	**43,778**	**41,164**	**387,766**

[1] Tax law as in effect on January 1, 1985, was applied to the 1983 level and sources of income and their distribution among taxpayers. Statistics include all returns and exclude nonfilers.

[2] Expanded income equals adjusted gross income plus excluded capital gains and various tax preference items less investment interest to the extent of investment income.

[3] Individual income tax liabilities take account of the refundable portion of the earned credit but do not take account of changes made by the Deficit Reduction Act of 1984 to income averaging, the capital gains holding period, and certain other provisions.

Note: Detail may not add to total due to rounding.

Appendix B

FORMS OF TAX EXPENDITURES

EXCLUSIONS, EXEMPTIONS, DEDUCTIONS, CREDITS, PREFERENTIAL RATES, AND DEFERRALS

Tax expenditures may take any of the following forms: (1) special exclusions, exemptions, and deductions, which reduce taxable income and, thus, result in a lesser amount of tax; (2) preferential tax rates, which reduce taxes by applying lower rates to part or all of a taxpayer's income; (3) special credits, which are subtracted from taxes as ordinarily computed; and (4) deferrals of tax, which result from delayed recognition of income or from allowing in the current year deductions that are properly attributable to a future year.

Computing Tax Liabilities

A brief explanation of how tax liability is computed will help illustrate the relationship between the form of a tax expenditure and the amount of tax relief it provides.

CORPORATE INCOME TAX

Corporations compute taxable income by determining gross income (net of any exclusions) and subtracting any deductions (essentially costs of doing business).

The corporate income tax approaches an average rate of 46% above $100,000 taxable income. Below $100,000 taxable income is taxed at graduated rates in four income brackets of $25,000 each:

Percentage tax rate	*Taxable income*
15	0–$25,000
18	$25–$50,000
30	$50–$75,000
40	$75–$100,000

The limited graduation provided in this structure was intended to furnish tax relief to smaller corporations.

Any credits are deducted from tax liability calculated in this way. The essentially flat statutory rate of the corporation income tax means there is very little difference in marginal tax rates to cause variation in the amount of tax relief provided by a given tax expenditure to different corporate taxpayers. However, corporations without current tax liability will benefit from tax expenditures only if they can carry back or carry forward a net operating loss or credit.

INDIVIDUAL INCOME TAX

Individual taxpayers compute gross income which is the total of all income items except exclusions. They then subtract certain deductions (deductions from gross income or "business" deductions) to arrive at adjusted gross income. The taxpayer then has the option of "itemizing" personal deductions or taking the standard deductions. The taxpayer then deducts personal exemptions to arrive at taxable income. A graduated tax rate structure into which the standard deduction is built is applied to this taxable income to yield tax liability, and any credits are subtracted to arrive at the net after-tax liability.

Exclusions, Deductions, and Exemptions

The amount of tax relief per dollar of each exclusion, exemption, and deduction increases with the taxpayer's marginal tax rate. Thus, the exclusion of interest from State and local bonds saves $50 in tax for every $100 of interest for the taxpayer in the 50-percent bracket, whereas for the taxpayer in the 25-percent bracket the saving is only $25. Similarly, the extra exemption for persons over age 65 and any itemized deduction is worth twice as much in tax saving to a taxpayer in the 50-percent bracket as to one in the 25 percent bracket.

In general, the following deductions are itemized, i.e., allowed only if the standard deduction is not taken: medical expenses, specified State and local taxes, interest on nonbusiness debt such as home mortgage payments, casualty losses, certain unreimbursed business expenses of employees, charitable contributions, expenses of investment income, union dues, costs of tax return preparation, uniform costs and political contributions. Whether or not a taxpayer minimizes his tax by itemizing deductions depends on whether the sum of those deductions exceeds the limits on the standard deduction. Higher income individuals are more likely to itemize because they are more likely to have larger amounts of itemized deductions which exceed the standard deduction allowance. Homeowners generally itemize because deductibility of mortgage interest and property taxes generally leads to larger deductions than the standard deduction.

Preferential Rates

The amount of tax reduction that results from a preferential tax rate (such as the reduced rates on the first $100,000 of corporate income) depends on the difference between the preferential rate and the taxpayer's ordinary marginal tax rate. The higher the marginal rate that would otherwise apply, the greater is the tax relief from the preferential rate.

Credits

A tax credit (such as the investment credit) is subtracted directly from the tax liability that would accrue otherwise; thus, the amount of tax reduction is the amount of the credit and is not contingent upon the marginal tax rate. A credit can (with one exception) only be used to reduce tax liabilities to the extent a taxpayer has sufficient tax liability to absorb the credit. Most tax credits can be carried backward and/or forward for fixed periods, so that a credit which cannot be used in the year in which it first applies can be used to offset tax liabilities in other prescribed years.

The earned income credit is the only tax credit which is now refundable. That is, a qualifying individual will obtain in cash the amount of the refundable credit in excess of his tax liability when he files his tax return for the year in which the credit applies.

Deferrals

Deferral can result either from postponing the time when income is recognized for tax purposes or from accelerating the deduction of expenses. In the year in which a taxpayer does either of these, his taxable income is lower than it otherwise would be, and because of the current reduction in his tax base, his current tax liability is reduced. The reduction in his tax base may be included in taxable income at some later date. However, the taxpayer's marginal tax rate in the later year may differ from the current year rate because either the tax structure or the applicable tax rate has changed. Furthermore, in some cases the current reduction in the taxpayer's tax base may never be included in his taxable income. Thus, deferral works to reduce current taxes, but there is no assurance that all or even any of the deferred tax will be repaid. On the other hand, the tax repayment may even exceed the amount deferred.

A deferral of taxes has the effect of an interest-free loan for the taxpayer. Apart from any difference between the amount of "principal" repaid and the amount borrowed (that is, the tax deferred), the value of the interest-free loan—per dollar of tax deferral—depends on the interest rate at which the taxpayer would borrow and on the length of the period of deferral. If the deferred taxes are never paid, the deferral becomes an exemption. This can occur if, in succeeding years, additional temporary reductions in taxable income are allowed. Thus, in effect, the interest-free loan is refinanced; the amount of refinancing depends on the rate at which the taxpayer's income and deductible expenses grow and can continue in perpetuity.[1]

○

---

[1] The tax expenditures for deferrals are estimates of the difference between tax receipts under the current law and tax receipts if the provisions for deferral had never been in effect. Thus, the estimated revenue loss is greater than what would be obtained in the first year of transition from one tax law to another. The amounts are long run estimates at the level of economic activity for the year in question.